

an eye on east asia and pacific

9 Rising Inequality with High Growth and Falling Poverty

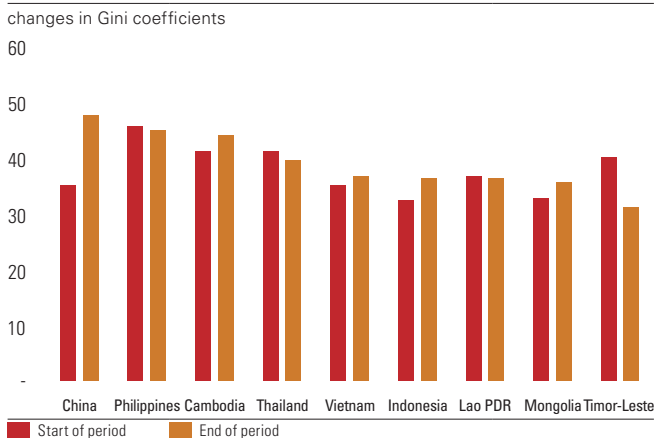
by Manohar Sharma, Gabriela Inchauste, and Juan Feng *

Inequality is on the rise in several countries in East Asia, most notably in China. The good news is that poverty declined rapidly at the same time. The bad news is that rising inequality is contributing to social tensions and those left behind represent a significant waste of human potential. An important driver of inequality in East Asia has been the change in the sectoral composition of growth away from agriculture and toward industry and services, driven in part by increased global integration. Policies that broaden access to higher levels of education, facilitate labor mobility, and connect leading and lagging regions will serve to simultaneously stem rising inequality and accelerate the pace of economic development and poverty reduction.

Inequality is rising

The unprecedented decline in poverty in East Asia and the Pacific during the past three decades has been accompanied by an increase in income inequality in several countries. Inequality has increased most dramatically in China but has also risen in countries as varied as Indonesia, Mongolia, Vietnam, and Cambodia even while inequality has tended to decline in many Latin American countries (Figure 1 and Figure 2). The Gini coefficient, which measures inequality, amounts to 48.2 percent in China, 45 percent in the Philippines, and 40 percent in Thailand, all higher rates than those that prevail in most countries in Eastern Europe and South Asia.¹

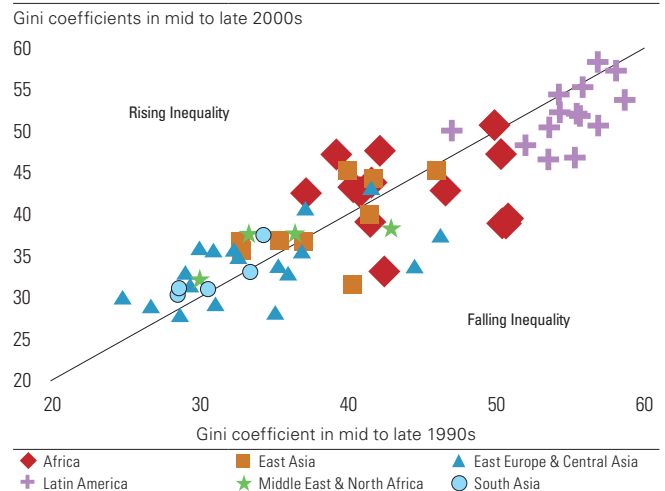
Figure 1. Inequality is high and rising in some countries...



Sources: National Household Income and Expenditure Surveys, and East Asia Poverty Database.

Note: The start and end dates are: China (1989-2004), Philippines (1997-2006), Cambodia (2004-07), Thailand (1998-2009), Vietnam (1998-2008), Indonesia (1999-2009), Lao PDR (1997-2008), Mongolia (2002-07), Timor-Leste (2001-07).

Figure 2. ...and exceeds levels in Eastern Europe and South Asia...



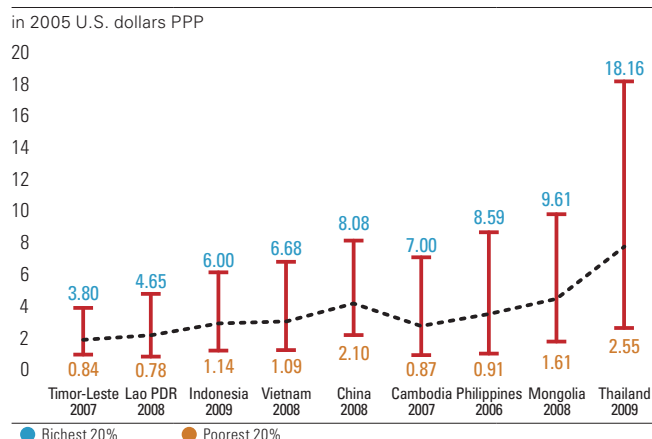
Sources: Povcalnet, SEDLAC, and East Asia Poverty Database.

* This note has benefitted from comments provided by Andrew Mason and Ivailo Izvorski.

¹ Cross-country comparisons are fraught with difficulties as some use income based measures while others use consumption based measures. Definitions of consumption across space and time can also be different. Hence the figures above provide a rough approximation of economic inequality across countries.

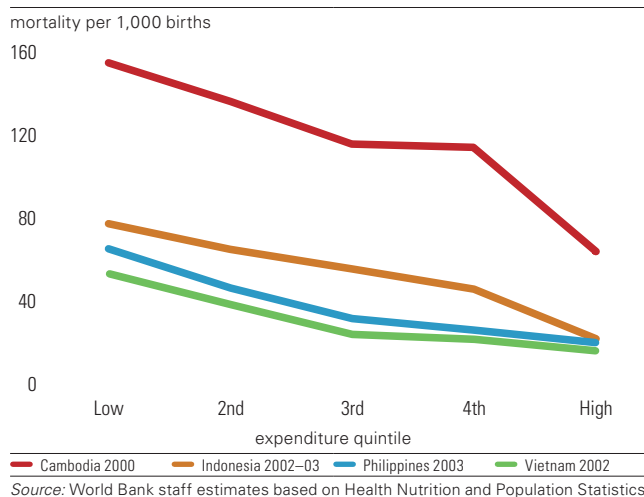
As a result, the region's policymakers are increasingly concerned about inequality and social mobility in their countries. While the region has less rigid social stratification than South Asia and while there is less inequality than in Latin America and Africa, policymakers fear that large and growing inequality, if left unaddressed, will polarize society, lead to social tensions, and eventually undermine the growth process itself. In the Philippines, the richest 20 percent of the population outspend the poorest 20 percent by about nine times, in Cambodia by about eight times, and in Thailand by about seven times (Figure 3). Asset inequalities are probably larger. Such large disparities, especially when perceived to be generated in ways lacking legitimacy, have the potential to weaken social cohesion and fuel social strife. Further, if increasing inequality dampens the pace of poverty reduction, as it has already started doing in China, it can exacerbate the already stark differences between the poor and the non-poor. Rapidly rising inequality is particularly unsettling in transition countries with recent, more egalitarian pasts, as the unfolding of these disparities is likely to be much more apparent than in other countries.

Figure 3. Disparities in expenditures between the richest and the poorest 20 percent are large



Sources: Various Household Income and Expenditure Surveys, and East Asia Regional Poverty Monitoring Database.

Figure 4. Under-five mortality rates are higher for poorer groups



Of special concern are inequalities in access to basic human services that affect current wellbeing and have the potential to cause long-term harm. Access to proper health care in the early stages of childhood, for example, can have lasting effects on both physical and mental development. These effects can, in turn, affect children's future productivity, earnings, and economic well-being. Poorer households in Cambodia, Vietnam, Indonesia, and the Philippines have significantly less access to primary care and experience higher under-five mortality rates than better-off households (Figure 4).

Concern about inequality has led several governments in the region to take action. Countries such as China are now deliberately pursuing policies to promote more "harmonious" social outcomes, and even historically unequal countries such as the Philippines have recently launched social transfer programs aimed at reducing disparities in access to basic education and health.

While markets lead to inequality based on effort, skills, and innovation, international experience suggests that there is considerable diversity in growth and inequality paths across countries. Public policies can play an important role in shaping those pathways. China's experience offers little support for the view that there is an aggregate trade-off between inequality and growth. While it is true that inequality has tended to rise over time, the periods of more rapid growth were not accompanied by more rapid increases in inequality: periods of falling inequality (1981–85 and 1995–98) were those with the highest growth in average household income.² Similarly, Brazil, a country with historically high levels of income inequality, experienced declines since the mid-1990s alongside modest growth.³

² Ravallion (2010).

³ Ferreira et al. (2008).

Changing economies, changing wage premia, and rising inequality

One factor driving changes in income distribution in East Asia is the realignment of activity away from agriculture and towards industry and services. During the last decade, growth in industry and services far outpaced growth in agriculture in all of the countries in the region. In China, growth in the industry and services sectors has generally outpaced agricultural growth rates for the last 25 years.⁴

Skill premiums are rising across the region and are now contributing to increased inequality. The skill premium is still rising because the growing demand for skills is not being matched by increasing supply (Figure 5 and Figure 6). This is particularly true for China, Cambodia, Mongolia and Vietnam. In Mongolia, skills shortages have been amplified by emigration of skilled labor. In Indonesia, the Philippines, and Thailand, demand for skills is also on the rise but only moderately more than the availability of skilled workers.

Figure 5. The proportion of worker with skills have mostly increased...

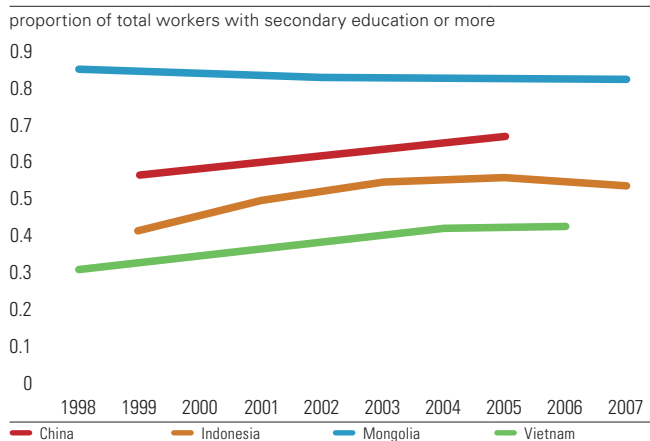


Figure 6. ...as has the wage premium due to secondary education

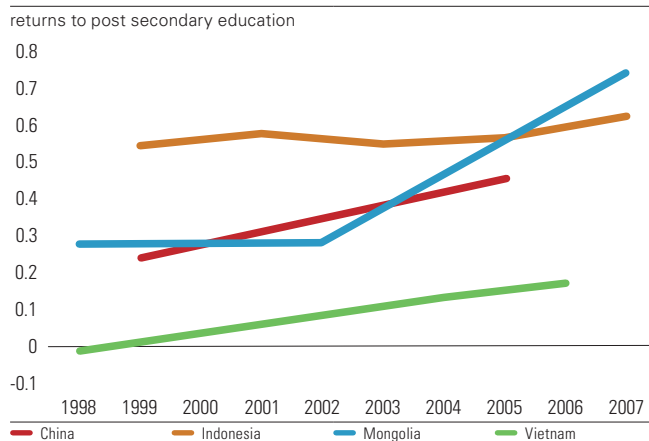


Figure 7. Access to post secondary education in Thailand is even more unequal than income

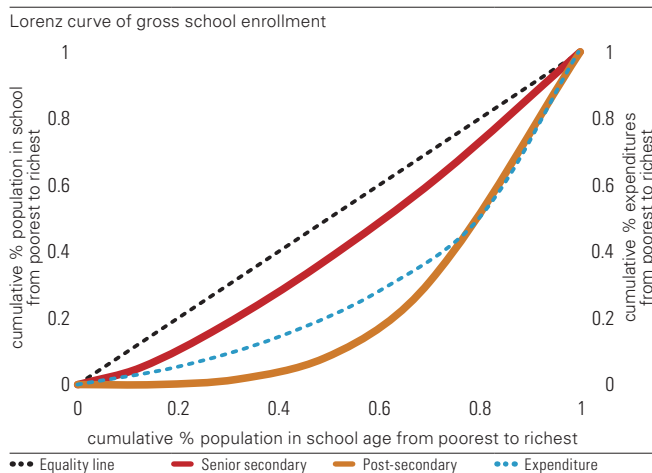
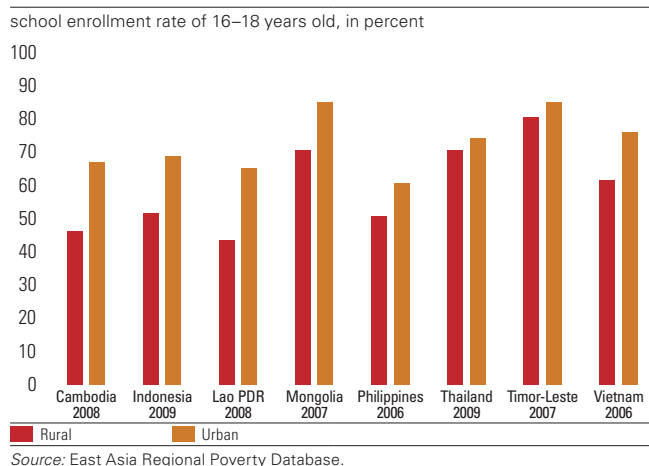


Figure 8. Enrollment in secondary schools is uniformly lower in rural areas



Rising skills premiums mean that completing primary school is no longer enough to enable a worker to get a good job. Inequalities in educational attainment in secondary and tertiary schooling have become an increasingly important source of eventual unequal incomes. Jobs are increasingly going to higher-skilled workers throughout the region, effectively leaving behind those with no advanced training. In China, a junior high school education and, in some instances, a senior high school

4 Ravallion and Chen (2007).

education has become a *de facto* prerequisite for accessing any non-farm work, particularly in urban areas.⁵ While the region has made immense progress in making primary education accessible to all, access to post-secondary education is still uneven. In Thailand, for example, there is near equality in primary and secondary education, but post-secondary enrollment is about as unequal as household consumption expenditure (Figure 7). In the rest of the region, there are important differences in secondary school enrollment between urban and rural areas, particularly in Cambodia, Indonesia, and Lao (Figure 8).

In China, the concentration of growth in urban areas is beginning to create a rural-urban divide in employment and earning possibilities. This development was exacerbated until recently by the much more rapid development that occurred in coastal areas than in inland areas (Figure 9 and Figure 10).⁶ As a result, most of income inequality in China (40 percent) is now accounted by rural-urban differences in income levels (Figure 11). However, in many of the other countries in the region including Timor-Leste, Lao PDR, Cambodia, Thailand, and Vietnam, intra-rural inequality predominates. Exceptions include Indonesia, the Philippines, and Mongolia where intra-urban inequality accounts for a major portion of total inequality. Nonetheless, it remains a fact that the poorest households in the region continue to rely on agriculture for their livelihoods while the wealthiest are more likely to be employed in the service sector (Figure 12). If productivity growth in agriculture lags and if the poor are less able than others to take advantage of new employment opportunities in growing sectors, then rural-urban inequality is also likely to increase in other countries in the region as well.

Figure 9. Inland-coastal disparity in China has increased with global integration...

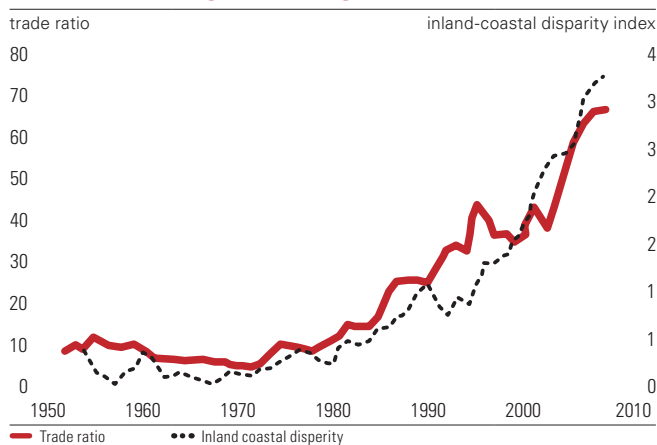


Figure 10. ...but regional inequality appears to be declining

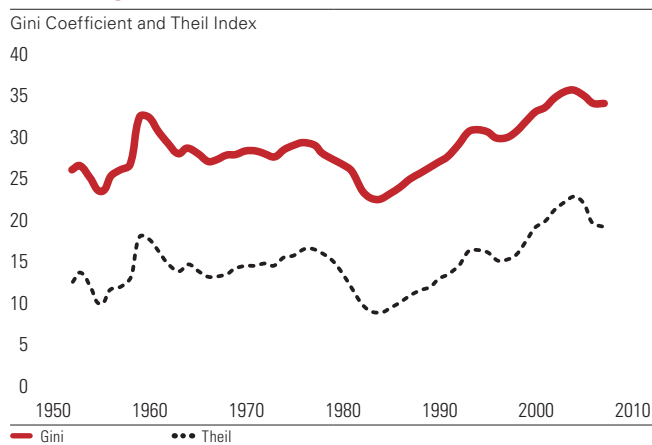


Figure 11. Rural-urban inequality contributes most to total inequality in China

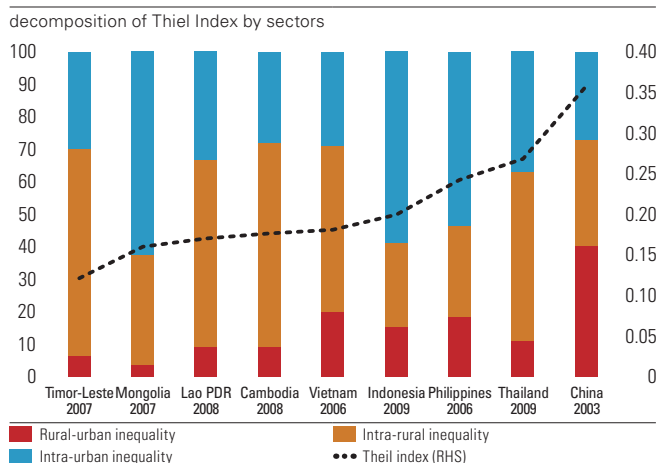
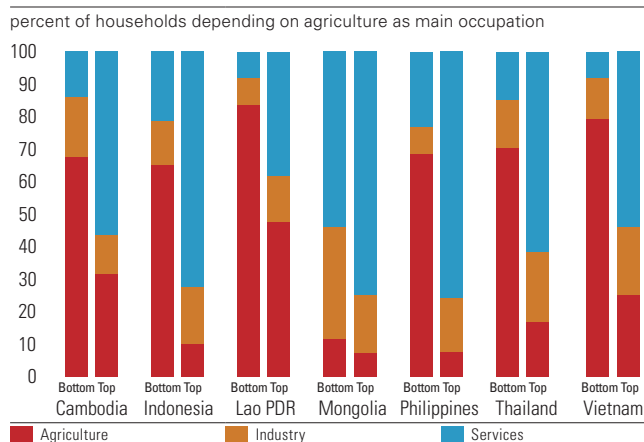


Figure 12. The poorest generally depend on agriculture



5 Ravallion (2010).

6 Fan S., R. Kanbur, and X. Zhang, 2010.

A lack of infrastructure linking urban areas with rural areas and other barriers to labor mobility have further accentuated inequality in some countries. For example, the *hukou* system of household registration in China means that people living in rural areas are not able to take advantage of the economic opportunities in urban areas. A lack of infrastructure linking the rural hinterland with production networks in coastal and other geographically favored areas means that firms and businesses located in rural areas face cost disadvantages when competing in both national and global markets.⁷ Public investments in infrastructure that improve geographical accessibility therefore have the potential to reduce inter-regional inequality. In fact, a slight reduction in inland-coastal disparity was detectable after 2000 in China when the government significantly increased infrastructure investments to connect the remoter western regions to the eastern coast (Figure 10).

Is rising inequality in East Asia inevitable?

Rapid technological progress and the continuing export orientation of East Asian countries means that the composition of growth of East Asian economies will continually change. The extent to which people are able to move between regions and sectors to take advantage of new and emerging sources of growth will determine how income and wealth are shared across the population. This will largely depend on how smoothly labor and other factor markets function to provide necessary information, signals, and incentives to all segments of the population. As segmentation and roadblocks in labor markets will increasingly exacerbate inequality, the quality of labor market policies pursued by governments in the region will matter even more.

Further technological progress will mean that all economic activities are likely to be skill-intensive in the future. Hence access to higher post-secondary education will have an important bearing on how inequality unfolds in the region. Public investments that increase access to quality secondary and post-secondary education will therefore be critical to ensuring that poor who face credit and other constraints to financing higher education are able to acquire the necessary skills to compete in the market place.

Internal migration will continue to be an important equalizing force in most countries. Industrial and service sectors will continue to expand as East Asian economies mature. This will mean that future growth centers will more likely be in bigger cities and in regions with favorable geography. Ability to migrate to these locations to either work or start a business will be critical in raising income levels of those that live in less advantageous locations. Impediments to migration, whether ethnic, social, economic, regulatory, or geographic, will only accentuate inequality.

However, reducing regional disparities cannot be accomplished just through migration. Level playing fields in accessing basic opportunities in health and education will be needed to ensure that inequality does not reflect deeper social or geographic exclusion. Provision of basic public services will therefore have to be spatially blind in this respect. There will also be many cases when infrastructural investments to connect towns, provinces and regions will provide lagging regions the cost advantage to compete. Fresh approaches will therefore be needed to identify the resource endowments and comparative advantage of each region. Fresh approaches will also be needed to assess which infrastructure investments will yield the highest payoffs in terms of increasing access to and integration with key markets, both domestic and international. Innovative ways must also be found to create institutions that promote and facilitate sustainable economic activities in less favorable locations.

Finally, social protection policies will be needed to assist the poorest and the most vulnerable. To the extent that unequal incomes are rooted in unequal capabilities, efforts to reduce income disparities will need to focus on across-the-board improvements in skills and capabilities rather than on compensating taxes and transfers that can distort incentives and overburden fiscal systems. Nonetheless, social transfers may have a role in the short-term to help the poor overcome financial obstacles in acquiring basic skills needed to compete in new and emerging markets. Also, appropriate pension and social transfer systems will be important to addressing the needs of the elderly or the disabled, for whom skills development and/or relocation are not viable options. Creating the needed fiscal space to do this will require achievement of a political consensus—to attack income inequality and uphold some basic norms of fairness and human dignity.

7 Zhang and Zhang (2003).

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