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View of two stages-Growing income and No-Income in Developing Asia

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ABSTRACT

This paper argues that growing income and no income inequalities in developing Asia pose a clear and present danger to social cohesion, political stability, and therefore the sustainability of growth itself. The rapid creation of productive economic opportunities combined with significantly broadening access to these opportunities, particularly for the bypassed and marginalized, must be ensured. Progressively lifting the well-being of a greater share of the population will contribute toward harmony

I. INTRODUCTION

While developing Asia's economies continue to grow at some of the fastest rates in the world, concerns about widening inequalities in standards of living and of the poor being bypassed by growth are becoming widespread. How correct is this perception, and how broadly does it apply to a region as diverse as developing Asia? To the extent that inequalities have grown, what are its drivers? What are the implications for policy?

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II. INCOME AND NONINCOME INEQUALITIES IN DEVELOPING ASIA

In a study of 22 developing Asian countries, seven have Gini coefficients of about 0.40 or more while the rest have a Gini coefficient between 0.30 and 0.40 (ADB 2007). In the international context, these do not represent particularly high levels of inequality, especially when compared with many Latin American and some sub-Saharan African countries, where Gini coefficients of 0.50 or even higher are common. Nevertheless, inequality remains a concern in developing Asia.

First, moderate levels of income inequality can coexist with high levels of inequality in areas that are essential for human well-being. Consider the distribution of severely underweight children across wealth quintiles. Both India and Pakistan—countries that do not register particularly high income inequalities—have very unequal measures of health status across their populations with different income levels. In India, for example, about 5 percent of children are severely underweight among the richest 20 percent of households. In the poorest 20 percent of households, this share is as high as 28 percent. Educational outcomes show a similar pattern. Most South Asian countries have very unequal educational attainments (ADB 2006). Second, low levels of income inequality can also coexist with high levels of inequality in asset ownership and access to infrastructure services. Landholdings can be fairly concentrated even if incomes/expenditures are not, as in India and Pakistan. More generally, household wealth—essentially ownership of physical and financial assets—tends to be unambiguously more unequally distributed than incomes or expenditures (Frankema 2006).

Concentration of wealth or assets implies that potential economic opportunities can be difficult for the economically disadvantaged to seize. Something similar happens when public infrastructure is distributed very unequally across a country. A great proportion of the population in lagging subnational regions in developing Asian countries has no access to electricity, sanitation, or clean water. This is true especially for the South Asian countries India and Nepal (Banerjee et al. 2007).

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III. WHY DOES INEQUALITY MATTER?

A. Increases in Inequality and the Impact on Poverty Reduction

Increases in inequality dampen the poverty reducing impact of growth. Thus, the increasing inequality in most parts of Asia is a cause for concern. A review of expenditure and income data reveals that over a roughly 10-year period spanning the early 1990s to the early 2000s, 15 developing Asian countries experienced an increase in the Gini coefficient (ADB 2007). Especially large increases took place in Bangladesh, Cambodia, People's Republic of China (PRC), Lao People's Democratic Republic, Nepal, and Sri Lanka. Meanwhile, absolute inequality increased virtually everywhere. Thus, even in countries such as Indonesia and Malaysia where Gini coefficients have declined over the last decade, the absolute dollar gap in per capita expenditures/incomes between the top 20 percent and bottom 20 percent has increased.

Given these increases in inequality, poverty reduction would have been higher—sometimes considerably so—had the economies in question been able to achieve their growth in mean per capita expenditure with their previous and more equal distributions. Worsening inequality may detract from the goal of poverty reduction. Bangladesh, Cambodia, and Nepal provide good examples. In the PRC, if inequality had not worsened, poverty would have been 5.7 percentage points lower in 2004.

B. Inequality, Economic Growth, and the Evolution of Economic Well-Being

More generally, examining the evolution of inequality is useful because it can provide valuable information on how different members of society are engaged with the overall growth process. There is often a tendency among both scholars and development practitioners to equate economic development with the rate of growth of per capita incomes. Even if incomes or expenditures are accepted as appropriate measures of economic well-being, the behavior of average incomes may say little about the economic well-being of different subgroups of the population. Underlying many of the cases of increasing Gini

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coefficients is a growth process in which the expenditures/incomes of the top 20 percent of the distribution have grown considerably faster than those of the bottom 20 percent. The differentials in expenditure are especially stark in terms of changes in the levels of expenditure as opposed to growth rates. In fact, increases in expenditure levels have been higher for the top 20 percent than for the bottom 20 percent even in countries where Gini coefficients have declined, for example, Indonesia and Malaysia.

To what extent do the differential rates of growth really matter? Consider again the case of the PRC, only now contrasting it with India. Inequality in terms of the Gini coefficient has not only been higher in the PRC (in both 1993 and 2004), it has also increased more dramatically than in India. But what if the focus were on the absolute gains among the poorest 20 percent of the population? That is, in which country has economic well-being (or standards of living) increased more for the poorest 20 percent? From this perspective, although inequality has grown faster in the PRC, mean expenditures of the poor have increased more than in India.

Indeed, some observers may go further and treat the rapid increase in inequality in the PRC as a natural outcome of rapid growth in a developing economy. Such a view would certainly be consistent with the idea of the Kuznets curve (or the inverted-U hypothesis) in which inequality first rises and then falls with economic growth.

However, this view presents two problems. First, as a large number of studies have demonstrated, the evidence for the Kuznets curve is weak. A rapid and sustained rise in inequality is not an inevitable result of high economic growth. The income-based Gini coefficient for two newly industrialized economies—Republic of Korea and Taipei,China—never touched 0.40 during their phase of rapid growth between the 1970s and 1990s, and even declined over some periods. Conversely, a reduction in inequality as a result of continuous economic growth beyond a turning point is also not a foregone conclusion.

Second, particularly high levels of inequality may have an adverse impact on future growth and development prospects. Given the evidence for increasing inequality in many developing Asian countries, this is highly pertinent.

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C. *Does a High Level of Inequality Help or Hinder Growth Prospects?*

A dominant view in post-World War II development circles was that high inequality facilitated the growth process. An important rationale for that view was provided by Nicholas Kaldor, whose work in this area appeared in a series of papers in the 1950s (Schmidt-Hebbel and Serven 2000). Large-scale investments in infrastructure were seen to be critical in jump-starting industrialization and economic growth. In the context of weakly functioning capital markets, some concentration of income and wealth could help spur investment if the marginal propensity to save was higher among the rich (i.e., capitalists) than the poor (i.e., workers). This was because a larger share of national income in the hands of the rich would imply a higher savings rate for an economy and, consequently, higher investments, greater capital accumulation, and more growth. A second reason to connect higher inequality with higher economic growth pertains to the role of incentives. An economic regime that does not reward effort or provide incentives for entrepreneurship is likely to be one with low inequality; it may also be one with low growth.

However, other mechanisms suggest that high levels of inequality will dampen growth (Fields 2001). Many of the specific mechanisms highlighted by recent literature work either through "wealth effects" or political economy arguments. In the case of wealth effects, the underlying factor linking high inequality with lower growth is the idea that tomorrow's wealth or incomes depend not so trivially on today's. People with little wealth or low incomes are unable to invest in wealth- or income-enhancing activities and remain poor. In principle, they may be able to borrow to finance investment. But imperfect financial markets, coupled with other market failures—all of which can be safely assumed to be widespread in developing countries—can seriously constrain the ability of otherwise creditworthy individuals to borrow in order to finance investments in education or business opportunities, or even to insure themselves from the risks associated with potentially

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profitable ventures. In this way, the prospects for a large group of individuals to raise their future incomes are compromised. Seen from the perspective of wealth effects, what is of interest is that redistribution of assets (and reduction of the collateral requirements for financing investment), far from having adverse distortionary effects, will be growth-enhancing.

As for political economy considerations, one class of arguments links higher inequality to the pressure to redistribute, for example, on account of the political power of the "median voter." Redistribution, in turn, lowers growth if it is executed through transfers that are distortionary. For example, redistribution that is financed by a tax on capital will reduce investment and growth. Alternatively, the process of bargaining that accompanies the call for redistribution, ranging from peaceful but prolonged street demonstrations all the way to violent civil war, may be costly.

Another class of political economy arguments works through the adverse effects of inequality on the quality of institutions and/or policies (World Bank 2006). If high levels of inequality give high-income individuals greater ability to tilt economic outcomes and policies toward themselves, growth prospects may well diminish. At a relatively benign level, bribery may result in some wasted resources as a wealthy individual or group of individuals lobbies government for the award of a contract. Much more pernicious is the situation where individuals with great wealth or high income use their economic resources to alter institutions and policies in their favor, with possibly damaging consequences for future growth.

IV. INEQUALITY AND PUBLIC POLICY

What does the foregoing discussion suggest about the stance of public policy vis-à-vis inequality? Two points are worth noting.

A. High Levels of and Increases in Inequality should not be Ignored

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As many Asian countries experience growing inequality in incomes or expenditures, they would do well to recognize some of the pitfalls of high inequality, to which both theory and international development experience point. At a minimum, high or growing inequality indicates that relatively poorer individuals are drawing proportionately fewer benefits from, or participating less in, growth. High or increasing inequality suggests that growth is not particularly broad-based. Additionally, growing inequality may lead to a deterioration in social cohesion and/or in the quality of institutions and policies, and ultimately in the prospects for economic growth.

B. Inequality: The Role of Effort versus Circumstances

In dealing with inequalities, it is useful to consider whether the inequalities or increases in inequalities are driven by differences in effort or by differences in circumstances outside the control of individuals (Roemer 2006). While it would be unfair to hold individuals responsible for the circumstances they find themselves in, they may be held responsible for their efforts. Distinguishing between circumstances and effort, and even defining them precisely, can be difficult. Nevertheless, it provides a useful starting point for thinking about how policy should deal with inequality.

For example, the inequalities in basic health and educational outcomes are bound to represent, to a large degree, inequalities due to circumstances. Such inequalities are doubly pernicious in that they detract from well-being today and often trap individuals in poverty. Key challenges for public policy are in (i) identifying which features of the economic and social landscape create circumstances that trap individuals into cycles of poverty and low incomes, and (ii) designing policy interventions that can alter these circumstances without dampening the rewards that accrue to effort.

The distinction between inequalities resulting from circumstances and those arising from effort is useful for the design of public policy. Public policy must address the disadvantages of circumstances that are unacceptable from both an economic and ethical viewpoint, and must

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contribute toward ensuring equality of opportunity. Once an even playing field is created, differences in effort will lead to differences in outcomes in terms of income and wealth. Clearly, even when public policy ensures equality of opportunity, inequality as an outcome could increase from different levels of effort, risk taking, and entrepreneurship. Circumstance-based inequality or bad inequality is unacceptable. Effort-based inequality or good inequality is acceptable (Chaudhuri and Ravallion 2007).

Asia's success in addressing extreme poverty in the last two decades is laudable. With prudent policies for growth and distribution, extreme poverty will be largely eradicated by 2020 (Ali and Zhuang 2007). However, rising income and nonincome inequalities are making it very important to shift the focus to increasing opportunities for all. In particular, in addition to about 500 million workers who are underemployed, the Asian demographics suggest that over 300 million new entrants will join the job market by 2020 (Felipe and Hasan 2006). To find decent and productive jobs for the underemployed and to reap the benefits of the demographic dividend, inclusive growth will need to be ensured. This will entail generating opportunities from economic growth on a massive scale, and sharing these opportunities equitably.

Inclusive growth ensures equal opportunity for all to enjoy the fruits of growth while avoiding extreme deprivation for people whose circumstances prevent them from benefiting from the opportunities created by growth. Inclusive growth requires a three-track approach. First, efficient, sustainable, and environmentally friendly growth must be ensured to generate new productive opportunities. Second, the economic and political playing fields must be leveled so that everyone can participate in, contribute to, and benefit from the new opportunities. Third, effective and efficient social protection systems must be strengthened to ensure that extreme deprivation is eliminated.

The second and third tracks constitute the core of inclusiveness. Inclusiveness requires leveling the playing field, with social policy "filling the burrows" to counterbalance the disadvantages that some face as the result of circumstances beyond their control. Such social policy will include health, education, sanitation, water, and housing services. Fundamental

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institutional and governance reforms aimed at addressing market, policy, and institutional failures will be required to improve access to these social services. In turn, capability enhancement must be accompanied by the creation of productive and decent employment opportunities for the less well-off and to ensure that they get access to these opportunities. Opportunities for all, combined with effort, would then be translated into outcomes. The third track would require fiscal transfer to people who face extreme deprivation. Higher growth rates are conducive to fiscal resource mobilization to finance the fiscal transfers.

While creation of employment opportunities is a firm- and farm-level issue, the investment and business climate in which firms and farms operate are influenced by public policy and investment. Institutional and governance reforms in the formulation and implementation of public policy and public investment will be needed to ensure that the disadvantages of circumstances are indeed addressed to create an even playing field for all segments of society and for all regions in a country.

In developing Asia, the sustainability of stellar growth rates will hinge on broadening inclusiveness. While the adoption of an inclusive growth strategy is a natural evolution in Asia's development process, the reform agenda required is complex and ambitious as reforms relating to policies, institutions, and governance that reduce both economic and political inequality will need to be addressed simultaneously. In Asia's tryst with the 21st century, it still has much work yet to do.

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