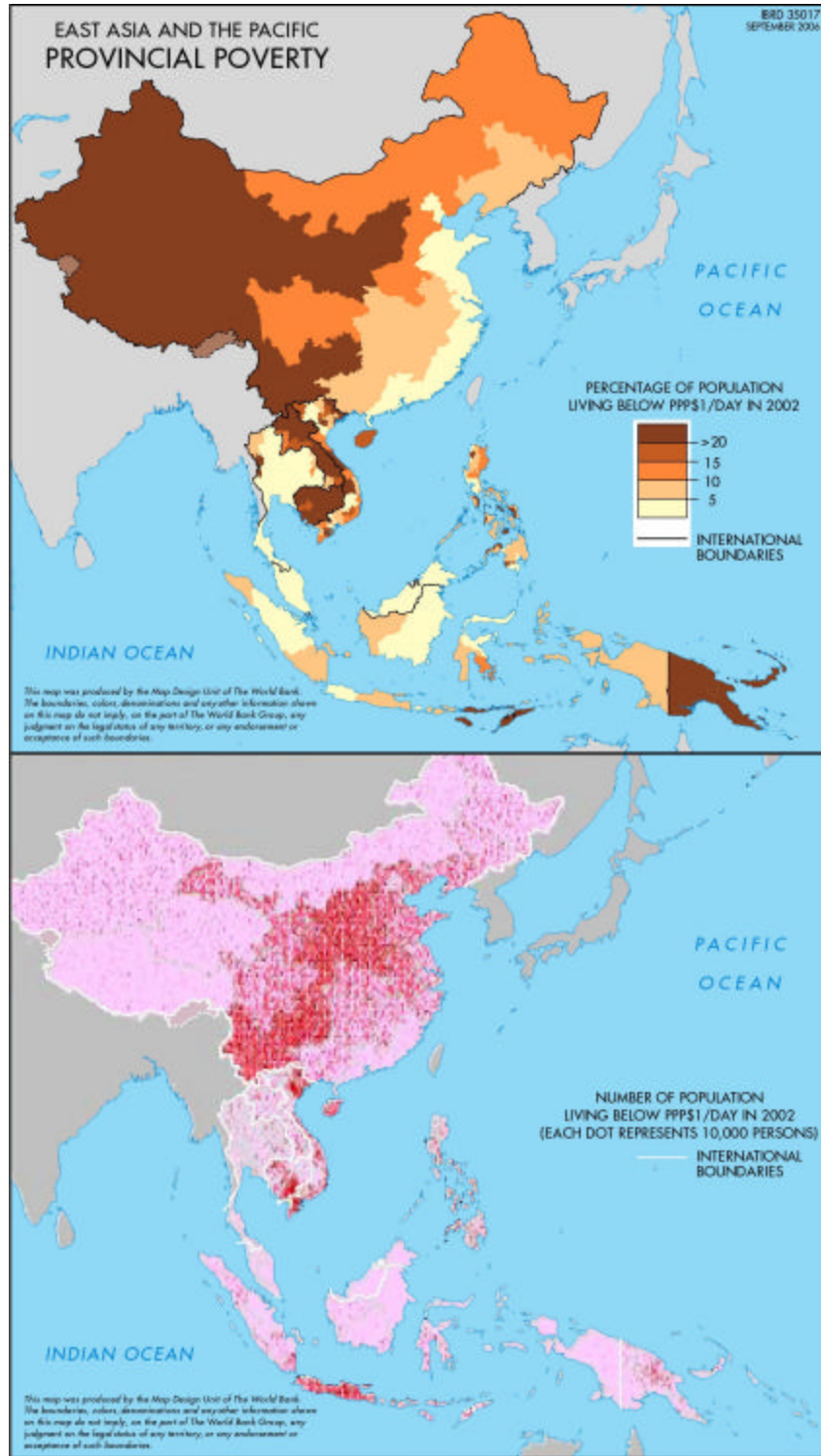


## 6. Cohesion

Map 6: Poverty in East Asia



Source: Based on calculations by World Bank staff.

## 6.1 Introduction

Much has been written about East Asia's stellar growth performance over the last two decades or so. The record is well known. As Chapter 1 notes, in terms of GDP per capita growth East Asia has been the fastest growing region in the world and that too by a fair margin. The massive growth in living standards is reflected in the fact that between 1980 and 2004, average GDP per capita levels in the region increased 4.5 times while world GDP per capita grew by 50 percent. Per capita GDP levels in the region are now beginning to approach the levels Latin America and the Caribbean (LAC) had attained in the 1980s; regional GDP per capita in 2004 was about three-quarters of the LAC per capita GDP in 1980.<sup>151</sup> In hindsight, even the Asian crisis of 1997-8 appears to have been a minor hiccup in the unfolding of an overall robust growth experience.<sup>152</sup>

While this record is both impressive and uncontroversial, there remain concerns whether this growth has also successfully delivered on improving the lives of 1.9 billion people that inhabit the region. Looking beyond the averages, there are questions as to how widely the benefits of growth have been shared (Map 6), and whether the region has also successfully improved economic and social opportunities for the vast majority of the citizenry. In short, there are concerns regarding equity and social cohesion aspects of the development processes in the region. This chapter is an attempt to assess these concerns and the emerging implications for public policy.

In reviewing East Asia's development experience since the 1990s from an equity perspective, the following facts stand out.

- Absolute poverty—in terms of both the percentage and the absolute number of poor people—in the region has declined dramatically since the 1990s.
- Reduction of income poverty has also been accompanied by progress in overall human development indicators for the countries in the region.
- However, looking beyond extreme poverty, a large proportion of the region's population continues to subsist at fairly low levels of living.
- Inequality of income or consumption has increased significantly since the 1990s, and most of it is driven by the increase in inequality within countries.
- Even where relative inequalities do not show a trend, absolute disparities have been growing rapidly.

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<sup>151</sup> In 1980, per capita GDP in EAP was about 30% of that in LAC. As growth in LAC languished while EAP prospered, by 2004 this ratio was 64% (World Bank, 2005a: WDI Central Database).

<sup>152</sup> As Joseph Stiglitz remarked, "What is remarkable about East Asia is not that it experienced a crisis in 1997 but that it had experienced so few crises over the preceding three decades—two of the countries had not had one year of downturn and two had had one year of recession, a better record than any of the supposedly advanced and well-managed Organization for Economic Cooperation and Development (OECD) countries" (Stiglitz, 2001).

- Two fault lines of inequality within countries are of particular concern: (i) the urban-rural divide and (ii) the regional/ethnic divide. These divisions are apparent in both the income and non-income indicators of welfare.
- Vulnerability as the ex-ante risk of falling into poverty is emerging as a growing concern in the region.

The next section documents these trends in greater detail. The rest of the chapter then goes on to discuss some of the underlying forces driving these trends (section 6.3), why we should care about rising disparities (section 6.4), and some emerging implications for public policy (in the final section).

## 6.2 The main trends

### 6.2.1 Poverty

Table 6.1 sets out the record of poverty reduction in the region since the 1990s. The progress has been dramatic and historically unprecedented. During the 1990s, the proportion of population living below \$1/day declined from 29 to 14 percent—in absolute terms, a decline in the number of poor from 457 million to 248 million. Projections (based on macroeconomic/sectoral growth patterns and the most recent household survey data available for countries in the region) indicate that the current levels of \$1/day poverty are around 8% with the number of poor down to about 150 million. The region has already attained and well surpassed the MDG target of halving the 1990 absolute poverty by 2015.

**Table 6.1: East Asia's progress in poverty reduction since 1990 (those below \$1/person/day)**

	EAP	Cambodia	China	Indonesia	Laos	Malaysia	Philippines	South Korea	Thailand	Vietnam
<b>Population (million)</b>										
1990	1585.4	10.3	1143.3	178.2	4.2	18.2	62.6	42.9	55.6	66.2
2000	1789.6	12.7	1267.4	210.5	5.4	23.3	76.3	47.0	61.9	79.9
2005	1868.5	14.1	1307.7	226.1	6.1	25.5	83.7	48.3	65.1	86.1
<b>Mean cons. (1993 PPP\$/ person/day)</b>										
1990	2.24	1.84	1.88	2.02	1.29	6.42	2.97	9.90	3.38	1.37
2000	3.73	2.32	3.47	2.38	1.75	10.00	3.52	16.31	4.12	2.41
2005	5.32	2.61	5.43	3.05	2.11	12.06	3.76	18.21	5.16	2.97
<b>Headcount Index (% below \$1/day)</b>										
1990	28.8	32.5	31.5	20.6	53.0	2.0	19.1	< 0.5	12.5	50.8
2000	13.8	22.6	15.4	9.9	33.9	< 0.5	13.5	< 0.5	5.2	15.2
2005	8.0	17.3	8.9	4.4	20.0	< 0.5	10.8	< 0.5	1.7	7.9
<b>Number of poor (million below \$1/day)</b>										
1990	456.9	3.4	360.6	36.7	2.2	0.4	12.0	--	7.0	33.6
2000	247.8	2.9	194.8	20.9	1.8	--	10.3	--	3.2	12.1
2005	149.7	2.4	117.0	9.9	1.2	--	9.0	--	1.1	6.8

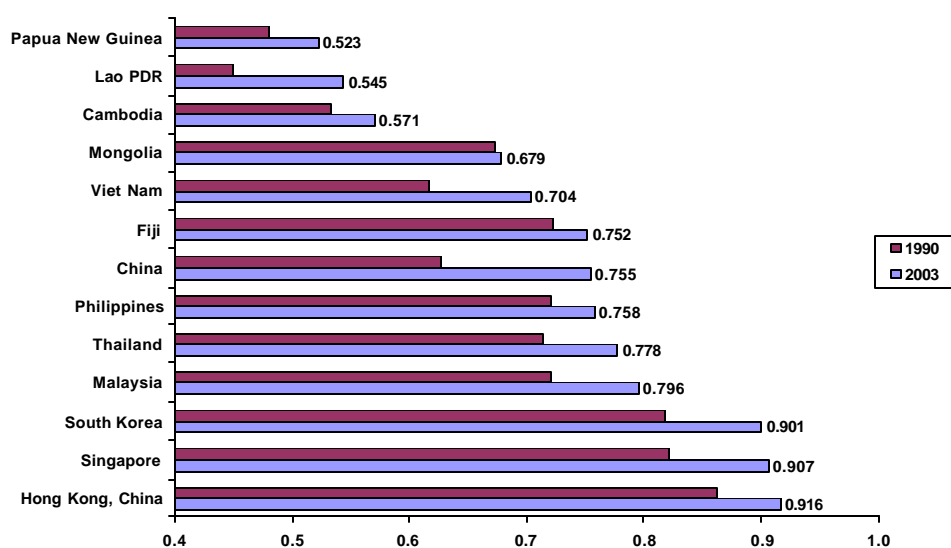
Source: World Bank (2006a), East Asia Update, March 2006.

While the regional aggregate numbers are dominated by the dramatic decline in poverty in China (from 361 to 117 million below \$1/day during 1990-2005), it is evident from Table 1 that progress has been rapid in most countries. Average consumption levels in the region and in most countries are now at levels where the virtual elimination of extreme (\$1/day) poverty is a potentially realizable objective.

Progress is also reflected in Human Development Indices (HDI) which are composite measures of development aggregating three indices: an index for life expectancy at birth, an education index (itself a combination of adult literacy rate and gross enrollment ratio) and an index for GDP per capita in purchasing power parity (PPP) dollars. As seen in Figure 6.1 most countries in the region have recorded significant improvements in HDIs during this period. Improvements are especially noteworthy for China, Vietnam, and Lao PDR. However, the disparities across countries are also striking; despite the improvement in HDIs across all countries, they nevertheless remain at quite different stages of economic and social development.

The extreme-poverty goalpost of a dollar-per-day is important. However, even the PPP-adjusted threshold of \$1.08 per day does not offer much in terms of the standard of living it affords.<sup>153</sup> It is hardly surprising that most countries have chosen to set their national poverty lines (typically based on a threshold of about 2,100 calories per person per day with some allowance for basic non-food expenditure) well above PPP \$1/day. However, going beyond \$1/day, there is a dramatic rise in the numbers at higher thresholds. For instance, it is estimated that nearly a quarter of East Asia's population currently has

**Figure 6.1: Human Development Indices in East Asia, 1990-2003**



*Source:* UNDP (2005), Human Development Report 2005.

<sup>153</sup> The dollar-a-day line actually refers to a threshold of \$32.74 per person per month, or about \$1.08 per person per day, in 1993 PPP dollars (World Bank, 2005b).

**Table 6.2: Challenge of reducing poverty for those below \$2/person/day—progress since 1990**

	EAP	Cambodia	China	Indonesia	Laos	Malaysia	Philippines	South Korea	Thailand	Vietnam
<b>Headcount Index (% below \$2/day)</b>										
1990	66.9	76.3	69.9	71.1	89.6	18.5	53.5	< 0.5	47.0	87.0
2000	45.8	67.8	44.8	59.5	79.4	9.7	47.2	< 0.5	35.6	63.5
2005	31.3	62.1	28.6	44.4	68.6	5.5	41.9	< 0.5	22.8	49.1
<b>Number of poor (million below \$2/day)</b>										
1990	1,060.8	7.9	799.6	126.7	3.7	3.4	33.5	--	26.1	57.6
2000	819.9	8.6	567.4	125.3	4.3	2.3	36.0	--	22.0	50.7
2005	584.5	8.7	373.5	100.5	4.2	1.4	35.1	--	14.8	42.3

Source: World Bank (2006a), East Asia Update, March 2006.

consumption levels between \$1 and \$2 per day. Altogether almost 585 million persons in the region—including large proportions of the population in many countries—are below the \$2-per-day benchmark (Table 6.2).

### 6.2.2 Inequality across and within countries

While poverty has declined and human development indices have improved, inequality within the region has grown. As seen in Table 6.3, the Theil index of inequality of per capita consumption for the region as a whole has increased from 34.5% in 1990 to 42.6% in 2002, an increase by about 24%. A decomposition of the overall inequality into between-country and within-country components indicates that most—about three-quarters—of the current inequality in the region is attributable to inequality within countries. In other words, even if all countries had the identical levels of mean consumption but relative disparities of consumption persisted within countries, the overall inequality in the region would only decline by about a quarter.

**Table 6.3: Evolution of inequality in East Asia, 1990-2002**

	Around 1990		Around 2002		Between 1990-2002	
	Theil index	Contribution to Theil index (%)	Theil index	Contribution to Theil index (%)	% Change in Theil index	Contribution to change in Theil index (%)
<b>Total</b>	<b>34.5</b>	<b>100.0</b>	<b>42.6</b>	<b>100.0</b>	<b>23.6</b>	<b>100.0</b>
<b>Between</b>	<b>12.0</b>	<b>34.8</b>	<b>10.0</b>	<b>23.6</b>	<b>-16.3</b>	<b>-17.7</b>
<b>Within</b>	<b>22.5</b>	<b>65.2</b>	<b>32.6</b>	<b>76.4</b>	<b>44.8</b>	<b>117.7</b>
<b>Within Theil index</b>	<b>22.5</b>	<b>100.0</b>	<b>32.6</b>	<b>100.0</b>	<b>44.8</b>	<b>100.0</b>
China	21.1	57.2	35.8	74.9	69.7	93.7
Indonesia	20.6	9.4	23.8	5.4	15.5	3.4
Lao PDR	19.8	0.1	23.1	0.1	16.7	0.1
Malaysia	35.2	5.2	36.7	3.5	4.2	0.5
Philippines	30.1	7.1	36.8	4.1	22.3	3.7
South Korea	17.0	9.1	17.5	6.0	2.9	0.6
Thailand	39.2	9.3	34.2	3.9	-12.8	-2.8
Vietnam	22.4	2.6	25.4	2.1	13.4	0.8

Source: Authors' calculations based on household survey data for these countries.

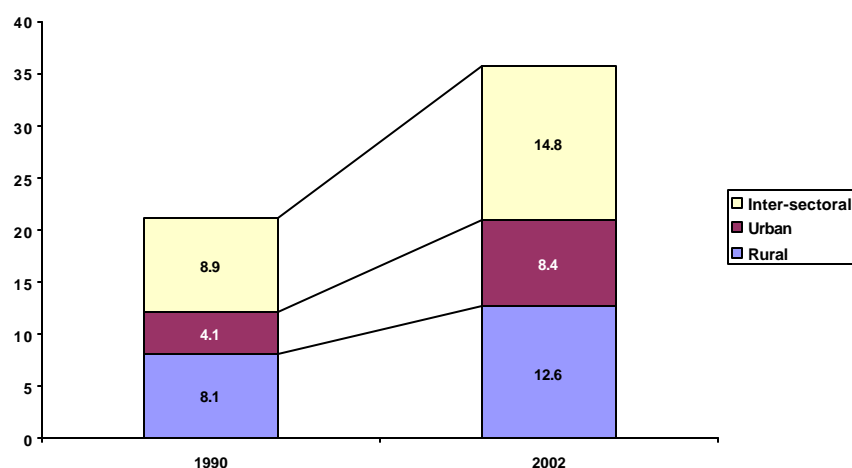
A key feature of the evolution of inequality in the region is the sharp increase in within-country inequality, while there has been a limited decline in inequality across countries. In terms of changes during 1990-2002, the between-country component declined by a modest 1.5 percentage points owing to more rapid growth in mean consumption in relatively poorer countries. However, as within-country inequality increased sharply by 9.6 percentage points, it resulted in an increase in overall inequality by about 8 percentage points.

As Table 6.3 also shows, inequality appears to have increased over this period in seven of the eight countries, the only exception being Thailand. Increases have been especially pronounced in China, but to a lesser degree also in Indonesia, Lao PDR, the Philippines, and Vietnam.

Changes in China are a big part of the story. The within-country component of regional inequality is a (consumption-share) weighted sum of inequality within individual countries. Given its large size, even in 1990 China contributed 57% to overall within-country inequality in the region. However, due to the sharp increase in inequality in China—its own Theil index increasing from 21.1% to 35.8%—as well as its growing prominence in the regional economy (reflected in its rising share in aggregate consumption from 61 to 68%), by 2002 China's contribution to the within-country component of regional inequality rose to nearly 75%.

Figure 6.2 presents a decomposition of inequality within China into components relating to rural and urban inequality and inter-sectoral inequality. During 1990-2002, all three components contributed to the rise in inequality. Inequality within both rural and urban

**Figure 6.2: Changes in inequality in China: A decomposition of Theil indices, 1990-2002**



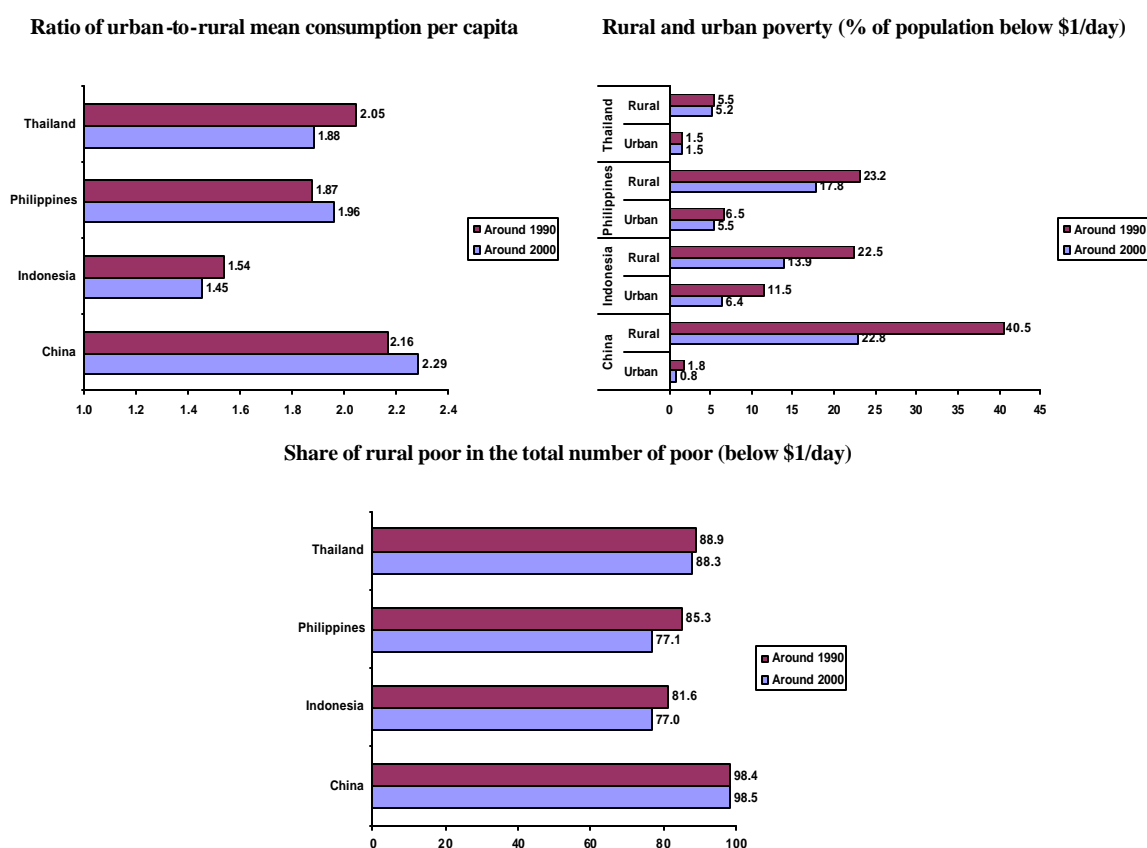
*Source:* Authors' calculations based on household survey data for China for 1990 and 2002.

areas increased, and inter-sectoral disparities rose sharply. Of the total increase in the Theil index between 1990 and 2002, the rise in rural and urban inequality contributed in equal measure—about 30% each—while rising inter-sectoral disparities contributed the remaining 40%.

### 6.2.3 The rural-urban divide

As the rising contribution of inter-sectoral disparity to overall inequality in China illustrates, the rural-urban divide is emerging as a key focal point of inequity in the region. This is evident in both economic and social indicators. For instance, Figure 6.3 shows the disparities in rural-urban consumption and poverty levels for four countries in the region. As seen in the Figure, average real consumption levels in urban areas are often about twice as large as those in rural areas. In countries such as China and Philippines, the gaps have been rising.

Figure 6.3: Urban-rural consumption and poverty disparities in four countries, 1990-2000



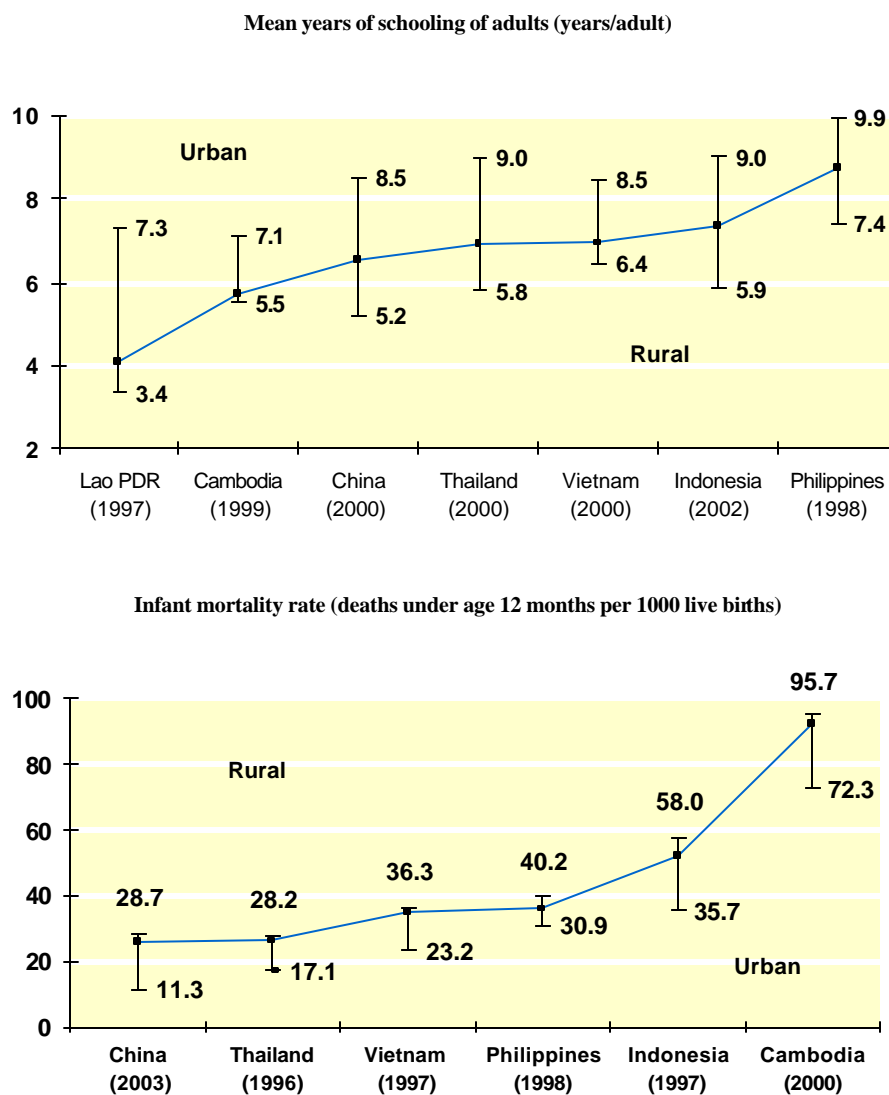
**Note:** Specifically, the estimates relate to the following years: China (1990, 1999); Indonesia (1990, 1999); Philippines (1988, 2000); Thailand (1992, 2000); Vietnam (1993, 2002). The estimates allow for urban-rural cost of living (COL) differentials within countries. For Indonesia, Thailand, Vietnam and the Philippines, these COL differentials (for any given year) are taken from the urban and rural poverty lines estimated for the poverty assessments for these countries. For China, an estimated urban-rural COL differential of 10% is used for 1990 which is then updated using urban and rural CPIs from national statistical sources.

**Source:** Authors' calculations based on household survey data for these countries.

These differences in mean consumption levels are magnified in the rural-urban poverty rates (Figure 6.3). While poverty has declined in both rural and urban areas over the 1990s, there are no signs of a significant narrowing down of the poverty differences between the cities/towns and the countryside. As a result, poverty in the region continues to be an overwhelmingly rural phenomenon.

Nor are the disparities limited to income or consumption. For instance, mean years of schooling of adults who are likely to have completed their education are between 2-4 years higher in urban than in rural areas (Figure 6.4). The average adult in rural areas in

**Figure 6.4: The rural-urban divide in education and health**



Source: World Bank (2005b), *World Development Report 2006: Equity and Development*; National Bureau of Statistics (NBS), China (2003); National Statistics Office. The connected line shows national mean values for the indicator.

many countries still has six or less years of schooling, and the average adult female has even fewer. Similarly, infant mortality rates in rural areas remain well above those in urban areas throughout the region. With the available data it is difficult to be conclusive about trends in these non-income aspects of rural-urban disparities, but there is no denying that substantial gaps remain a continuing source of friction in the region.

Evidence for China does, however, indicate some worsening of rural-urban disparities in education and health indicators. For instance, while illiteracy and infant mortality rates (IMR) declined in both rural and urban areas, the ratio of rural-to-urban illiteracy rate increased from 2.1 to 2.3 between 1981 and 2000, and similarly the ratio of rural-to-urban IMR increased from 1.7 to 2.8 over the same period (Zhang and Kanbur, 2005).

#### **6.2.4 *The regional and ethnic divide***

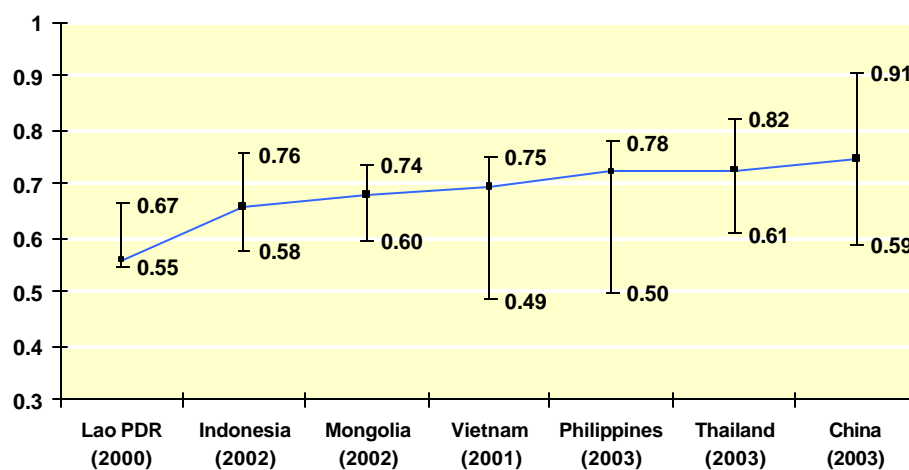
An equally important element of inequality within countries is regional disparity. Map 6 presents a province-level map of poverty for the region for the year 2002. For each province, it maps the proportion of population below \$1/day and also the absolute number of poor with each dot representing 10,000 poor persons. The provincial map highlights three features of the geography of poverty in the region.

- First, national averages hide large differences within countries. Low-income countries include provinces with low poverty incidence, and middle-income countries include provinces with high poverty incidence. There are some regularities across the region. Poverty incidence tends to be higher in the remote rural upland areas (for example, in Vietnam, Laos, and China's Yunnan province), in areas with a weak natural resource base, as in the Northeast of Thailand, and in areas distant from major urban centers. Conversely, poverty headcount ratios are generally lower in urban agglomerations and surrounding areas. Poverty incidence also tends to be higher in the interior provinces relative to coastal areas.
- Second, poverty incidence tends to be spatially clustered, and the clustering can transcend national borders. This suggests an important role of geography in determining poverty over and above the influence of national history, policies, and institutions. The sub-region with the most significant cross-border spillovers of poverty incidence is the Greater Mekong sub-region, which includes Yunnan province in China, Laos, Vietnam, Cambodia, and Thailand.
- Third, comparing the incidence of poverty with the number of the poor, poor areas are generally sparsely populated. For example, areas with high poverty incidence and low population density include the western provinces of China (Xinjiang and Tibet), the Northern Mountains areas of Vietnam, the upland areas of Laos, and the eastern provinces of Indonesia and Papua New Guinea. Low-incidence and high-density areas include the Mekong River and Red River delta areas in Vietnam, Vientiane plain and Mekong River Corridor in Lao PDR, and Luzon island in the Philippines. However, some areas have high poverty incidence and a large number of poor: for instance, the eastern provinces of Philippines, Java Island in Indonesia, Yunnan province of China and the Northeast region of Thailand.

Regional disparities are also notable in Human Development Indices (HDIs) across provinces. Based on the National Human Development Reports for seven countries in the region, Figure 6.5 presents the range of HDIs across provinces within each country. The provinces with low (high) HDIs are often the ones with high (low) poverty rates although the correlation is not perfect. For instance, for the Philippines for 2003, seven of the ten best and the worst-performing provinces in terms of poverty incidence were also amongst the ten best and worst-performing provinces in terms of the HDIs (Human Development Network (HDN) and UNDP, 2005).

There is also a significant ethnic dimension to inequality within countries that often also overlaps with the spatial disparities discussed above. Table 6.4 presents some evidence for China, Lao PDR, and Vietnam. For instance, in Laos compared with the majority community (Lao-Tai), the minority groups have much higher poverty and child malnutrition rates, lower net primary enrollment rates, and lower value of agricultural assets per capita, thus compounding their deprivation in multiple ways. It is notable that the Lao-Tai mostly live along the well-connected Mekong corridor, while the other ethnic minorities live mainly in the poorly connected upland areas in the North and Central South.

**Figure 6.5: Provincial disparities: Human Development Indices in East Asia**

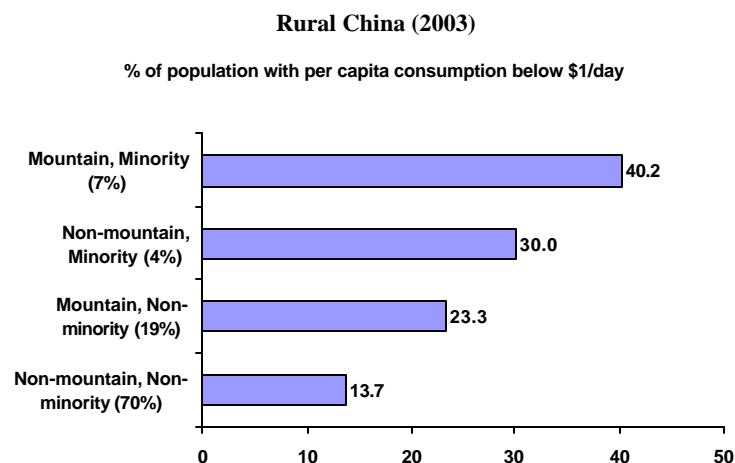


*Source:* National Human Development Reports for each country. The connected line shows the national values of the HDIs.

**Table 6.4: The ethnic dimension of disparities in some East Asian countries**

**Lao PDR (2002-3)**

	Share of population (%)	% who are poor	% of underweight children (under 5 years of age)	Net primary enrolment rate (%)	Value of agri. assets per capita (mil.Kip)
<b>Majority group</b>					
Lao -Tai	66	25	34	76	4.5
<b>Minority groups</b>					
Mon-Khmer	24	54	43	49	2.0
Hmong-lu Mien	3	46	41	35	2.0
Chine-Tibet	8	40	37	47	3.8



Note: Shares of different groups in total rural population noted in parentheses.

**Vietnam (1993-2002)**

	1993	1998	2002
% who are poor			
Kinh and Chinese	53.9	31.1	23.1
Ethnic minorities	86.4	75.2	69.3
Lower secondary enrolment rate (%)			
Kinh and Chinese	33.6	66.2	75.9
Ethnic minorities	6.6	36.5	48.0
% with access to clean water			
Kinh and Chinese	29.0	44.9	52.6
Ethnic minorities	5.3	9.9	12.8

Note: In 2002, the ethnic minorities had a 13% share in the Vietnamese population.

*Source:* Lao PDR: World Bank (2006b), Lao PDR Poverty Assessment Report; China: Based on calculations undertaken for the China Poverty Assessment; Vietnam: World Bank (2003), Vietnam Development Report 2004.

Similarly, in rural China poverty rates amongst the non-Han ethnic minorities are 2-3 times higher than among the Han population. Remoteness in terms of mountainous location further accentuates poverty amongst the minority communities. Again, it is notable that while only about a fifth of the Han population is located in mountainous areas, the proportion for the minorities is around two-thirds. The story is similar in

Vietnam where relative to the Kinh and Chinese majority, the ethnic minorities are a lot poorer in terms of their consumption levels, access to clean water, and school enrollment, especially at the lower secondary and post-secondary levels.

There is also evidence of increasing regional disparities over time for some countries, for instance, China. Using data on per capita consumption expenditure for rural and urban sectors of 28 provinces, Kanbur and Zhang (2005) report measures of regional inequality increasing significantly since during post-reform period; the Gini and Theil indices rose from about 26% and 11% in 1984 to 37% and 25% respectively in 2000.

Evidence on trends over time in ethnic disparities is often not readily available. One exception is Vietnam where the data clearly indicate that the improvements for ethnic minorities have not kept pace with the majority population (Table 6.4). This widening ethnic gap cannot be generalized for other countries. But the reality of large gaps is undeniable. Evidence such as that presented above for China and Lao PDR illustrates that despite all the growth and poverty reduction of the 1990s, ethnicity continues to be a significant axis of disparity in the region.

### **6.2.5 Vulnerability**

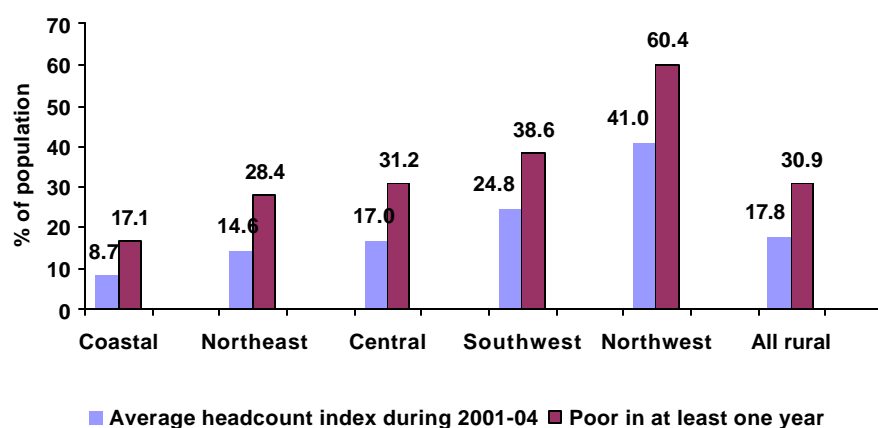
Cross-sectional data which underlie all of the evidence presented above are, however, limited in one important respect: they do not tell us how living standards of the same households change over time. Poverty reduction would be an easier problem to solve if the remaining poor at any given time were a fixed group of households. However, there is instead considerable income and consumption mobility, and in particular movement of people into and out of poverty. This has an important implication: the number of people who are at the risk of poverty can be appreciably larger than the number who are observed to be poor. This is illustrated by recent longitudinal data from rural China, which shows that as against 18% of the population who are observed to be poor on average during 2001-04, about 31% of the population are poor in at least one of the three years (Figure 6.6). Thus, for every poor person there is another one who faces a one-third or higher probability of being poor.

It is difficult to assess if the relative risk of poverty has been increasing in China or, more generally, within the East Asia region. However, sub-national-level evidence from China does indicate that as the incidence of poverty declines, the share of transient poverty tends to rise (World Bank, 2006d). If that is any guide, with East Asia's success in poverty reduction, the issue of transient poverty is likely to become more important.

## **6.3 Understanding disparities**

The uneven spread of economic growth within countries has thus been as compelling a feature of the growth experience in East Asia over the last two decades as has been the rapid pace of growth itself. Put differently, growth has been accompanied by “friction,”

**Figure 6.6: Average incidence of poverty (headcount index) and vulnerability (share of poor in at least one of three years) in rural China, 2001-04, using dollar-a-day line and per capita consumption as a measure of welfare**



*Source:* World Bank estimates, based on panel data from NBS' Rural Household Surveys for 2001, 2003, and 2004.

understood here as the widening, or at least the persistence, of disparities across space, sectors or groups, and ultimately across individuals. The two are not unrelated, of course. As argued below, much the same forces that have contributed to rapid growth have also shaped its unevenness. This section looks at five major drivers of friction in the region that have to varying degree influenced the emerging trends in different countries. These include: (i) trade and globalization, (ii) labor market reform, (iii) formation of clusters and agglomeration effects, (iv) the ongoing process of fiscal decentralization, and (v) impediments to what is otherwise an equalizing force: the process of internal migration within countries.

While the first two factors appear to have contributed to rising skill premia in East Asian labor markets, the third factor underlies much of the observed spatial concentration of economic activity, and the fourth factor has had significant implications for the equitable distribution of public spending, especially in education and health. Given the centrality of China to both the level and trends in inequality in the region, the following discussion pays particular attention to developments in China.

### **6.3.1 “China price” is not just cheap unskilled labor**

A key factor underlying the rise in inequalities within the region has been the widening of wage inequality.<sup>154</sup> There has been a significant trend increase in the returns to education

<sup>154</sup> For China, Benjamin, Brandt, Giles, and Wang (2005) estimate that on decomposing income inequality by source of income, wage income was the largest contributor to overall income inequality in both urban

in several countries reflecting rising skill premia in labor markets. For instance, in urban China, returns to completing levels of education above the senior high school increased sharply during 1988-2001 (Figure 6.7). Those completing technical school earned 3% more than senior high school graduates in 1988; by 2001, this increased to 18%. Similarly, college graduates earned 12% more than senior high school graduates in 1988, but 37% more in 2001.<sup>155</sup> The increasingly high returns to education suggest that the so-called “China price,” that has been instrumental in making China “the factory of the world,” is not just a matter of abundant supply of cheap unskilled labor.

A similar pattern of rising skill premia is also notable for Vietnam during 1993-2004, and for male workers in urban Indonesia during 1980-2004, while trends for Thailand indicate some increase since the 1998 crisis but appear to be flat over the longer period from 1994 to 2002 (Figure 6.7). In Thailand’s case, however, there is some evidence of an increase in relative returns to higher education during an earlier period from 1985 to 1998 (Hawley, 2004). Similarly, there is also evidence of increase in skill premia for Taiwan (China) for the period 1979-94 (Bourguignon, Fournier, and Gurgand, 2005), while rates of return to different levels of education remained stable for Malaysia over the period 1989-97 (Fields and Soares, 2005).

Thus, while not universal, there is evidence of rising returns to skills in several countries in the region. Moreover, the rise in these wage premia has often occurred despite increases in the relative supply of skilled labor over this period. For instance, the share of urban workers with college education increased from 13% to 28% in China during 1988-2001 (Zhang, Zhao, Park and Song, 2005); growth in post-secondary education in other East Asian countries also generally rose. This suggests that demand-side factors have been important, some of which are discussed below.

### ***6.3.2 Trade and globalization***

The sources of the East Asian growth “miracle” have been extensively studied.<sup>156</sup> One key factor that is especially relevant to the discussion of emerging disparities in the region has been the role of trade liberalization and the ability of the region to take advantage of greater global economic integration through foreign direct investment (FDI) and export-oriented industrialization. It is arguable that the particular pattern of trade and globalization while stimulating rapid growth in the region has also contributed to relatively faster growth in demand for skilled labor through various channels.

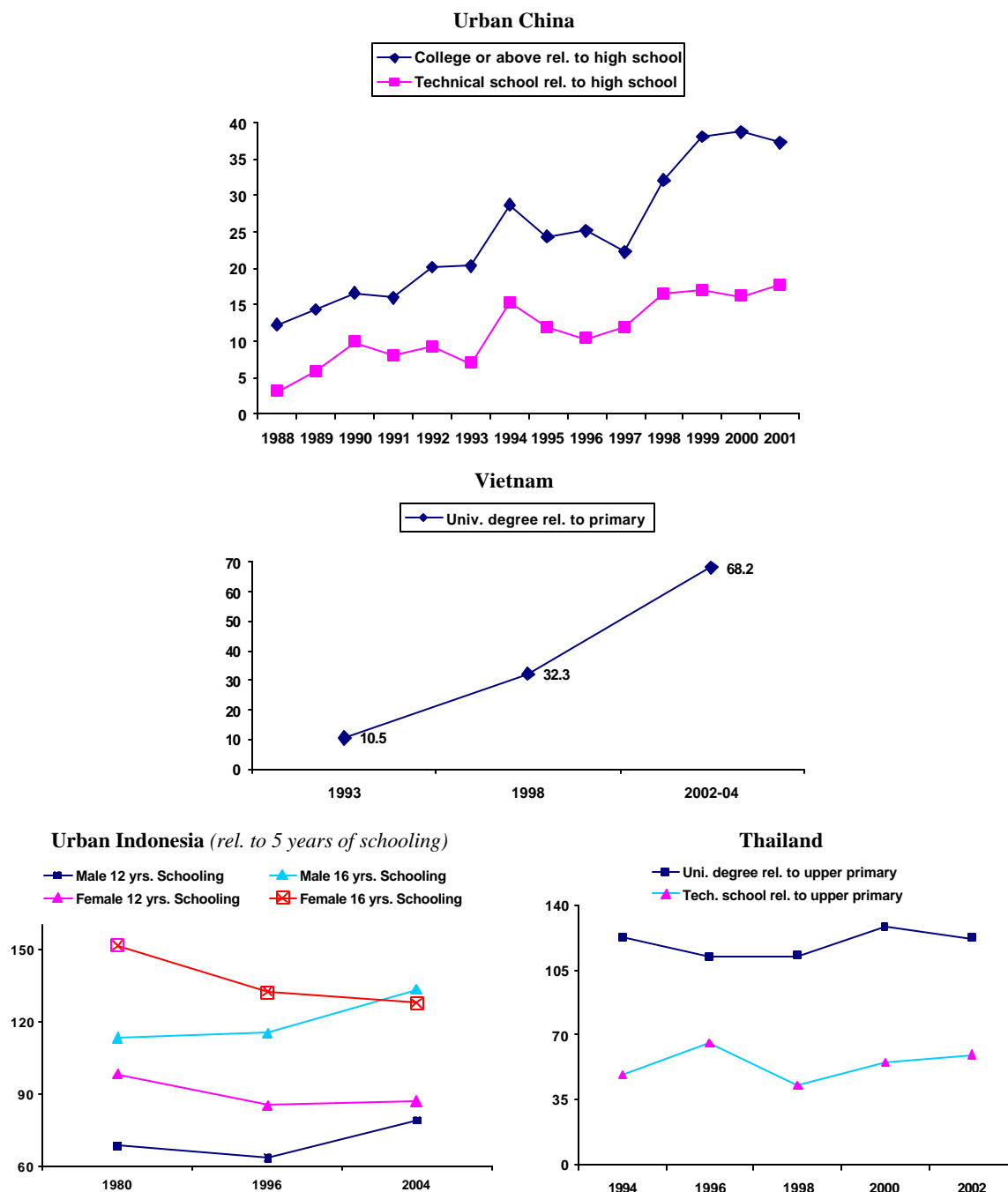
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and rural China in 2000/01; it was also the biggest contributor to the increase in inequality during 1987-2001.

<sup>155</sup> For further evidence of increasing returns to education in urban China and growing concentration of urban wages during 1995-2002, also see Khan and Riskin (2005).

<sup>156</sup> The literature on this is too voluminous to be referenced let alone summarized. For a detailed review of the East Asian growth experience following the crisis of 1997-98 and the subsequent recovery, see Stiglitz and Yusuf (2001).

Figure 6.7: Skill premia in the labor market: China, Vietnam, Indonesia, and Thailand



Note: The percentage impact on wages is measured on the vertical axis.

Source: For China: Zhang, Zhao, Park and Song (2005); for Vietnam: World Bank (2005c); for Indonesia, Alatas and Bourguignon (2005) and World Bank (2006e); and for Thailand, Blunch (2004).

First, in most East Asian economies, rapid economic growth and the structural transformations associated with that growth have expanded not only the traded manufactured goods sectors but also increased demand for financial, commercial, and other services and expanded these (still predominantly non-traded) skill-intensive sectors. Skilled labor supply is in less elastic supply in the short to medium term because of the costs and time associated with acquiring education. Hence, even a skill-neutral growth in labor demand (arising from economic growth) can widen wage dispersion for a period of time if supply elasticities differ across skill categories. As a result, in very rapidly growing economies such as China and Vietnam, we can reasonably expect to see some widening of wage disparities, even if no other forces are at work.

Second, the pattern of trade and globalization in the region has not conformed to the stylized Heckscher-Ohlin framework which predicts reduced wage dispersion in countries relatively abundant in unskilled labor. In this framework, trade liberalization leads countries to expand production of goods that are intensive in the factor they are relatively abundant in, thereby increasing the returns to that abundant factor. Since unskilled labor is the relatively abundant factor in developing countries, trade liberalization could be expected to reduce the relative returns to skilled labor in these countries. However, as noted above, skill premia have on the contrary increased in several countries in the region. This points to the role of other factors affecting such premia (for instance, labor market reform, as discussed below), but also to some important ways in which the simple Heckscher-Ohlin framework fails to capture the particular features of trade and globalization in the region. Two of these features are notable.

**International capital flows.** Contrary to the assumption of no international factor mobility in the standard Heckscher-Ohlin model, the ability to attract large amounts of foreign direct investment (FDI) has been a distinguishing feature of the development success of East Asia. The FDI-trade nexus in East Asia has contributed significantly to the narrowing the technology gap with the developed world, a by-product of which has also been increasing demand for (and wages of) relatively skilled labor through a number of channels. FDI has tended to be concentrated in relatively skill-intensive sectors in East Asian economies (Te Velde and Morrissey, 2004). FDI has also induced skill-biased technological change both through the technology directly brought in by foreign firms as well as through horizontal and vertical transmission to existing and new local firms (Hu and Jefferson, 2002; Keller, 2002). Foreign-owned enterprises have also tended to pay relatively more to (the relatively scarce) skilled labor than local firms.<sup>157</sup>

**Production networks.** Another significant development in the region has been the growth of production and distribution networks whereby the firms in East Asia have become increasingly integrated into global supply chains. The process of production has been “deverticalized” and fragmented such that lead firms in developed countries have

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<sup>157</sup> For instance, Zhao (2001, 2002) using data for 1996 for China found that even accounting for non-wage benefits (pensions, housing, and health care) for state-sector employees, skilled workers earned more and unskilled workers earned less in foreign-invested enterprises than in state-owned enterprises. For related evidence, see Lipsey and Sjöholm (2001) for Indonesia, Matsuoka (2001) for Thailand, and Ramstetter (2000) for Hong Kong (China), Malaysia, Singapore, and Taiwan (China).

sought to outsource the non-core fragments of the value chain to external suppliers. The phenomenon—greatly facilitated by the spread of recent advances in information and communication technology and logistics—is particularly developed in the manufacturing sector, but is by no means confined just to manufacturing. A measure of the growing importance of production networks in the region is the increasing importance of trade in parts and components.<sup>158</sup> The development of production networks and outsourcing has tended to increase the demand for skilled labor in both home and host countries, as the outsourced activities while being less skill-intensive in the home country are nonetheless more skill-intensive relative to the host country average (Feenstra and Hanson, 1996). Theoretical models that explicitly incorporate intermediate goods and product fragmentation generate results which suggest that trade liberalization and globalization can increase skill premia and widen wage dispersion.<sup>159</sup> While the mechanisms that link wage dispersion to higher levels of product fragmentation differ across various theoretical models, the complementarity of skilled labor with particular types of capital often emerges as an important one.

Direct econometric evidence of the contribution of increasing trade and globalization on widening wage dispersion in East Asian economies remains sparse, but the above theoretical insights and empirical observations are highly suggestive of such an effect, and the limited direct evidence is also consistent with this view. For instance, in a study of five East Asian countries—Hong Kong (China), South Korea, the Philippines, Singapore, and Thailand—during 1985-98, Te Verde and Morrissey (2004) find that trade and FDI tend to increase wage inequality.<sup>160</sup> Similarly, Kanbur and Zhang (2005) find that greater trade openness contributed significantly to the rise in spatial income inequality in China over the post-reform period.

### 6.3.3 Labor market reform

A factor that has been particularly important in transition economies such as China and Vietnam is the implementation of labor market reforms, associated with progressive reduction in share of the state sector in the economy and the accompanying fall in state-sector employment. Since the early 1990s, the *de facto* deregulation of labor markets in both China and Vietnam has progressed a great deal, and market forces play the dominant role in wage setting within the greatly expanded private sector. For example, in China the share of state-owned and collective sector in urban employment declined from over 85% in 1980 to less than 30% by 2004 (Park, Cai, and Zhao, 2006). Similarly, in Vietnam, the number of state-owned enterprises (SOEs) declined from about 12,000 at the end of 1989 to less than 2,600 by early 2006 (World Bank, 2006c). The share of private domestic and foreign enterprises in total employment rose from 11% in 1993 to over 18% in 2004

<sup>158</sup> Athukorala and Yamashita (2005) who report that while trade in parts and components has grown faster than total world manufacturing trade, East Asia's dependence on this form of trade is larger, and its growth relative to overall manufacturing trade faster than the rest of the world. Also see Okamoto (2005) for similar evidence on the changing spatial pattern and structure of trade in East Asia.

<sup>159</sup> See Ethier (2002) for instance.

<sup>160</sup> The positive effect of trade ratio was significant in their pooled regression; the effect of FDI was insignificant in the pooled regression, but significant for Thailand (Te Verde and Morrissey, 2004).

(World Bank, 2005c) while the SOEs and the government-sector only accounted for about 8% of total employment in 2004.

The effects of economic restructuring and labor market reform on wage and income inequality may work through a number of channels, as illustrated in the Chinese case. First, as wages begin to reflect skill-related productivity differences, wage dispersion across workers increases. The evidence for China indicates that returns to education increased both in the private as well as state and collective sector enterprises indicating that increasing wage dispersion was not just the result of a rising share of the private sector in overall employment, but wider labor market reforms involving a shift from a system of government-set wages along a compressed wage scale to a more market-determined system (Zhang, Zhao, Park, and Song, 2005).

Second, the massive lay-offs associated with economic restructuring meant that many (especially older workers) opted out of the labor force, and many others remained unemployed for long periods. Using data for five cities in China, Giles, Park, and Cai (2006) estimate that of all those experiencing job separation during 1996-2001, only about 35% were employed again within 12 months, and about 55% were still unemployed in November 2001. The limited public support available (through subsidies for laid-off workers, pensions, unemployment insurance and a minimum income support program) failed to compensate for the income loss for those who were not re-employed.<sup>161</sup>

Third, there is also evidence of greater wage disparity amongst those who were fortunate to find re-employment. For instance, Giles, Park, and Cai (2006) also estimate that among those who were re-employed, workers under 40 experienced an increase in their average wage, while those over 40 saw their average wage decline.

Fourth, a parallel process has been the growing share of employment in the urban informal sector. The share of such employment in urban China is estimated to have risen from about 14% in 1990 to about 39% in 2003 (Park, Cai, and Zhao (2006)).<sup>162</sup> While part of this increase may be “statistical,” reflecting some of the previously unrecorded economic activity, especially in the tertiary sector,<sup>163</sup> most of it seems to be on account of the rapid growth in the unregistered and imperfectly monitored private sector, unreported migrant workers, and a significant share of informal employment amongst urban residents employed in the state and collective sector.<sup>164</sup> The share of informal employment is higher for women, among youngest and oldest workers, for migrants and

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<sup>161</sup> Also see Meng (2004) for similar evidence.

<sup>162</sup> The phenomenon of high and rising share of informal employment in labor markets is not just limited to China. For parallel evidence for Indonesia and the Philippines, see ADB (2005).

<sup>163</sup> Based on the Economic Census of 2005, the National Bureau of Statistics made a 50% upward revision of the GDP for the tertiary sector in 2004 (with corresponding adjustments going back to 1994), raising the share of tertiary sector in GDP from 32 to 41% (Park, Cai, and Zhao, 2006).

<sup>164</sup> Cai and Wu (2006) use nine-fold criteria to determine informal employment. The most important categories include: self-employed workers, those working on a temporary or hourly basis, those without a labor contract and not considered officially registered workers. They estimate that 23% of employment in the state and collective sector in 2002 was informal, while the share of informal employment was as high as 84% in other sectors.

among less educated workers (Park, Cai, and Zhao, 2006; Cai and Wu, 2006). Workers in the informal sector not only have relatively lower wage earnings,<sup>165</sup> but, largely uncovered by protective regulation and social insurance programs, they are also the most vulnerable segment of the labor market.<sup>166</sup>

### **6.3.4 Agglomeration effects and clusters**

The emergence and growth of industrial and services clusters around large cities, and the persistent, and in many instances widening, disparities between dynamic growth regions and underdeveloped “lagging” regions is the most visible aspect of uneven growth in East Asia (for a detailed survey of clusters in East Asia, see Yusuf, 2003). Spatial concentration or clustering of economic activities reflects the influence of location and agglomeration economies. Transport costs and factor availability provide incentives for locating close to input suppliers and output markets, and increasing returns to scale magnify the advantages of locating in such clusters. Forward and backward linkages generate centripetal forces towards agglomeration, and distance (which influences market access) and market size begin to matter in industry location decisions. Firms that locate in a cluster enjoy access to thicker labor pools and component suppliers. Because agglomeration processes are path-dependent, an existing industry concentration can exert a powerful “gravitational pull” on new industries. These forces often complement rather than conflict with classical comparative-advantage-based locational factors that attract industries to locate and expand in particular cities or regions.

Such agglomeration effects while being a powerful lever for growth can also be a source of significant spatial inequality. Spatial disparities in average incomes across China’s metropolitan regions can be related to one dominant factor: distance from a port. These income differences are also reflected in provincial wage disparities: those in coastal regions gain a wage premium due to their location advantage (Lin, 2005).

While “first nature geography” (proximity to coast, rivers, borders) is often an instigating factor in the development of clusters and spatial concentration, the role of trade and foreign investment on the one hand and public policy on the other is being increasingly recognized (Yusuf 2003, Kanbur and Venebles, 2005). For instance, about 80 percent of FDI in China during 1989-2003 has been concentrated in the coastal provinces, and the three provinces of Ho Chi Minh City, Hanoi, and Dong Nai accounted for about 60 percent of FDI in Vietnam during 1988-2003 (Figure 6.8).<sup>167</sup> Analysis of foreign firms’ entry decisions for China reveals that they are influenced by access to international

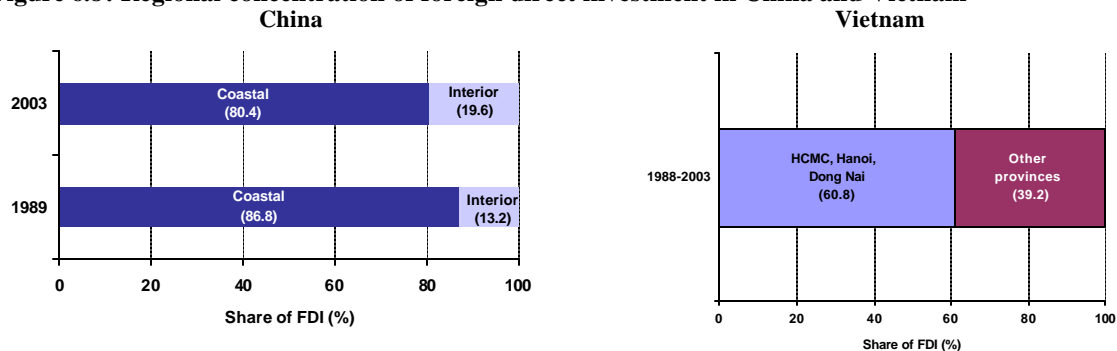
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<sup>165</sup> There is evidence of a significant, even growing, segmentation in the Chinese urban labor market. A large share of the difference of wage earnings during 1995-2002 between private domestic enterprises and state-owned or foreign-invested enterprises is not on account of differences in worker endowments, but due to higher wage premia in the latter sectors (Demurger et al., 2006).

<sup>166</sup> For instance, in 2002, the proportion of informal workers in urban China covered by pension, unemployment insurance, and health insurance were 34, 21, and 14% respectively as against 85, 73, and 62 for formal workers (Park, Cai, and Zhao, 2006).

<sup>167</sup> Altogether five provinces containing 15% of the country’s total population accounted for 74% of total FDI in Vietnam (Leproux and Brooks, 2004).

**Figure 6.8: Regional concentration of foreign direct investment in China and Vietnam**

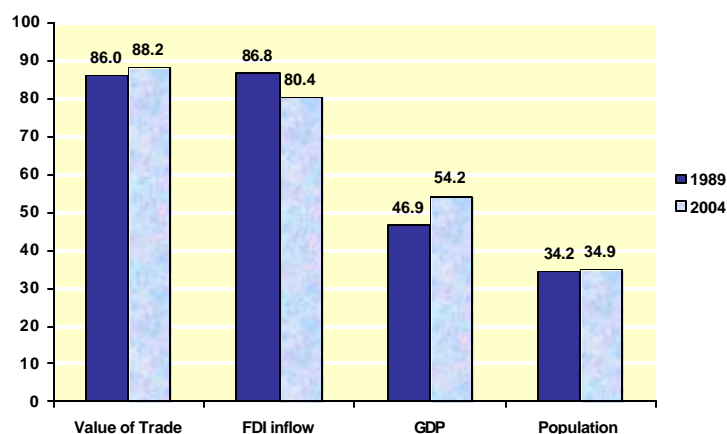


*Source:* China: National Bureau of Statistics, China Statistical Yearbooks (various years); Vietnam: Leproux and Brooks (2004).

markets and suppliers, so that provinces that have good access to sea and river berths and are open to international trade attract more foreign entry (Amiti and Javorcik, 2005).

These trends in FDI are also highly correlated with foreign trade. For instance, the top four provinces attracting FDI in China (Jiangsu, Guandong, Shanghai, and Shandong) accounted for about 56 percent of total FDI in 2003 and about 66 percent of the country’s total trade (exports plus imports).<sup>168</sup> As shown in Figure 6.9, the persistently high shares of coastal (relative to inland) provinces in trade and FDI are also reflected in growth of incomes. During 1989-2004, while the share of coastal provinces in total population

**Figure 6.9: Share of coastal provinces in trade, FDI, GDP and population in China, 1989-2004**



*Note:* The share of FDI for refers to the years 1989 and 2003. The shares of trade and GDP for 1989 refer to averages for the period 1986-91.

*Source:* National Bureau of Statistics, China Statistical Yearbook (various years); Zhang and Zhang (2003).

<sup>168</sup> Calculated from data reported in NBS (2005), China Statistical Yearbook 2005.

remained stable, their share in GDP increased from 47 to 54 percent, indicating a significantly faster growth of per capita incomes in the coastal region.

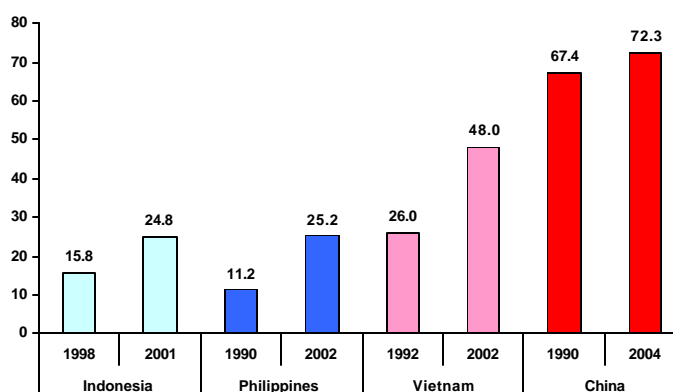
Domestic, public as well as private, investments have also favored the same regions. For instance, in 2004, coastal provinces in China also accounted for 55% of total domestic investment in fixed assets (NBS, China Statistical Yearbook, 2005). The locational advantages are thus magnified over time as a result of investments in superior infrastructure and facilities, all these in turn contributing to a growing geographical concentration of economic activity.<sup>169</sup>

It is then not surprising that growth has also been spatially concentrated. For China, it is estimated that about 19 percent of the increase in regional inequality (log variance of GDP per worker across provinces) during 1986-98 is explained by regional differences in trade and foreign capital, while nearly three-quarters is explained by domestic capital (Zhang and Zhang, 2003).

### 6.3.5 Fiscal decentralization

Another significant trend in East Asia that gained momentum during the 1990s has been the move towards greater fiscal decentralization. While different structural and political imperatives propelled the process in different countries (ranging from the end of authoritarian regimes in Indonesia and the Philippines, to the transition to a market economy in China and Vietnam), the share of sub-national government spending has risen in several countries in the region to significant (though varying) levels (Figure 6.10).

**Figure 6.10: Rising share of sub-national government expenditure in total government expenditure during the 1990s in East Asia**



*Source:* Indonesia: Brodjonegoro and Marinez-Vazquez (2002); Philippines: World Bank and ADB (2005); Vietnam: World Bank (2005d); China: National Bureau of Statistics (2005).

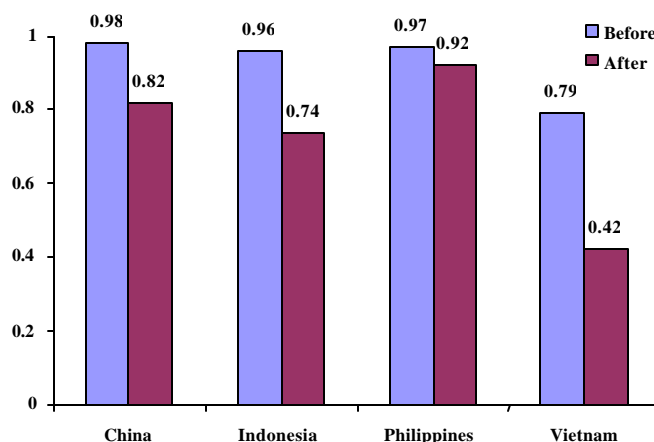
<sup>169</sup> See Wen (2004) for further evidence on growing regional concentration of manufacturing activity in China during 1980-95.

However, while fiscal decentralization has progressed, sub-national fiscal disparities remain persistently large. There are large differences in revenue capacity across local governments reflecting the underlying large variations in their economic and resource base. Vertical imbalances between sub-national revenues and expenditures are sought to be filled through transfers from the central government, but such transfers have not gone far in addressing horizontal inequality. Transfers from the central government reduce the disparities in per capita revenues but often not by much (Figure 6.11).

As a consequence, there are large disparities in per capita local government spending across lower levels of government. For instance, the Shanghai province in China spends 8 times as much per capita as Henan province.<sup>170</sup> Differences at the sub-provincial level are much larger still, the county with highest per capita expenditure spending 48 times as much as the one with the lowest (Dollar and Hofman, 2006).<sup>171</sup>

As may be expected, the differences in per capita spending are strongly related to the level of per capita incomes, as illustrated for China in Figure 6.12. The needier areas often get less. As the figure shows, the positive relationship between per capita GDP and provincial expenditures is equally strong for total provincial spending and that of education and health. In the case of public health as well as education, there is an increasing reliance on user charges such that the share of out-of-pocket expenses in total

**Figure 6.11: Coefficient of variation in provincial per capita revenues before and after transfers**

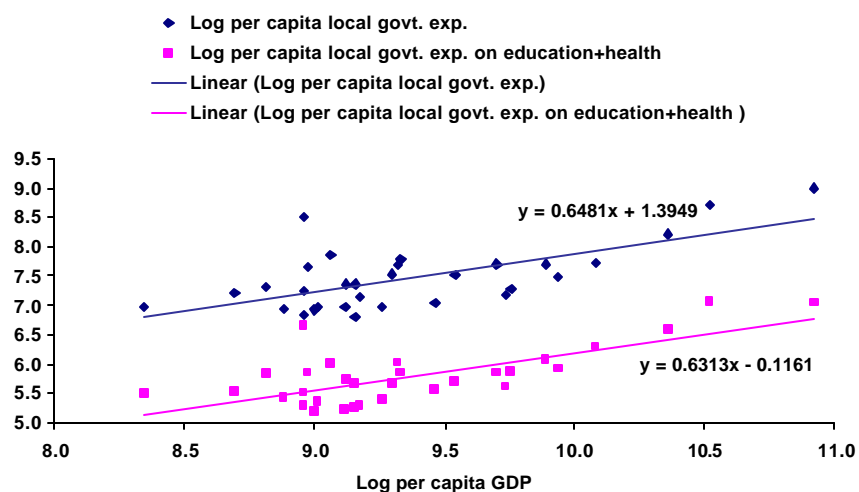


*Source:* Hofman and Guerra (2005).

<sup>170</sup> Similar fiscal disparities are also found for other countries in the region. For evidence on Indonesia, Philippines, and Vietnam, see Hofman and Guerra (2005). In relation to education spending, also see King and Guerra (2005) for evidence on disparities in per capita education spending across districts in Indonesia, and in per pupil Special Education Fund spending across municipalities in the Philippines.

<sup>171</sup> For related evidence on growth of fiscal disparities in China, see Wong and Bird (2005).

**Figure 6.12: Richer provinces spend more per capita than poorer provinces, China 2004**



*Source:* Authors' calculations based on data from National Bureau of Statistics (2005).

sectoral spending has grown rapidly (see World Bank, 2006d). While this may have filled some of the financing gap, out-of-pocket spending is often regressive, discourages utilization of services by the poor, and in the case of health shocks exposes households to financial risks.

These fiscal disparities are finally reflected in widely varying levels (and quality) of public services provided across regions. Hofman and Guerra (2005) provide some evidence of how spending disparities are related to education and health outputs and outcomes in China, Indonesia, and Vietnam. Further evidence for China also suggests that during the post-reform period fiscal decentralization has contributed to the increase in inequality of per capita consumption expenditures across provinces, rural and urban areas, and across coastal and inland regions (Kanbur and Zhang, 2005).

### 6.3.6 Impediments to internal migration

Over the past few decades, massive internal migration, especially from rural agricultural sector to urban secondary and tertiary industries, has been observed in a number of East Asian countries. For instance, household survey data for China suggest that the total population of rural migrant labor in 2004 was nearly 120 million (Sheng and Peng, 2005). For Vietnam, it is projected that the flow of migrants to urban areas could be almost one million every year over the next two decades (World Bank 2003). More generally, the level of urbanization has increased rapidly in all countries.

Labor mobility can be a powerful equalizing force through its effect on reducing wage and income differentials across regions and sectors. However, the persistence of disparities within many countries as noted above suggests that the equalizing role of migration has been more limited than may have been believed. In practice, a number of factors have inhibited the process of migration and its effect on reducing inequalities.

First, studies have suggested that the poorest households constrained by their limited endowments may be unable to make use of migration opportunities. Du, Park, and Wang (2005) and McKenzie and Rapoport (2004) find an inverted-U-shaped relationship between household endowments and the likelihood of migration. Specifically, Du, Park, and Wang (2005) find that households near the poverty line are most likely to migrate, and for those with lower or higher incomes, the probability of migration is lower. This suggests a minimum level of productive resources is required for poor households to take advantage of new migration opportunities.

Second, low education level and lack of training and qualifications limit employment opportunities for potential migrants. Du, Park, and Wang (2005) find lack of education and skill constitutes a major barrier to migration in China. Thus, with lower migration rates among the relatively poorer households, increasing migration seems to have contributed to some of observed rise in rural inequality in China.<sup>172</sup>

Third, the institutional environment in many instances is restrictive of labor mobility. For example in China, although overt restrictions on labor mobility have been eased to a large extent during the course of economic reforms, there is still a “guest worker” system in place where migrant workers continue to be tied to their land, are often deprived of services such as public education and healthcare at an affordable cost in cities, and are entitled to hardly any social protection. Similarly, the registration system in Vietnam, whereby migrants who do not have a place of residence do not get access to some basic services, is a key administrative barrier to geographical mobility of labor (World Bank, 2003).

Fourth, insufficient access to information can limit migration possibilities. Available evidence suggests a heavy reliance on informal networks in migration. For instance, Sheng and Peng (2005) find that the primary source of migrant employment information in China is families, relatives, and friends from the same province of origin. Those who migrate through the channel of government organization only account for less than 2 percent of all migrants. This indicates a significant inadequacy of formally organized sources of information that facilitate and assist migration processes.

## **6.4 Should we care about disparities?**

Since rapid growth in East Asia has also been associated with rapid poverty reduction, one may wonder if the persistence or the increase of inequalities as documented above should be particularly worrisome. One could indeed take the view that, since some of the factors that have been responsible for rising disparities are also the ones that have contributed to growth, the observed higher inequality is just the price to be paid for rapid growth. Alternatively, rising disparities could be viewed as transitional within a Lewisian model of development where the recent economic growth is seen to be characterized by

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<sup>172</sup> It is important to note that migrant workers are included in the rural (not urban) household surveys in China. Thus, increases in migrant workers’ incomes are reflected in rural rather than urban poverty and inequality measures. Benjamin, Brandt, Giles, and Wang (2005) note that the failure of the non-farm labor markets to provide enough income opportunities (mostly through migration outside the village) to offset the declining share of crop incomes was an important source of increase in rural inequality during 1987-2001.

the development of the modern sector. According to this view, as the modern sector continues to grow further to absorb ever-larger proportions of low-productivity labor from other sectors, disparities will eventually decline. Migration is seen to be an essential part of this process. While there is an element of truth to each of these viewpoints, there however remain several reasons to be concerned about the level and trends in economic and social disparities in the region.<sup>173</sup>

First and perhaps the most basic reason is that people care about inequalities. For instance, according to a 2002 household survey in urban China, more than 80 percent of the respondents considered the income distribution to be “either not so equitable” (48 percent) or “very inequitable” (34 percent) (UNDP, 2005).<sup>174</sup> Related evidence from the World Values Survey for East Asia is more mixed. On the particular question of whether large income differences are needed as incentives for individual effort, the majority of respondents in all seven countries participating in the survey favored such differences (Shin and Dalton, 2006). On the broader issue of “market capitalism”<sup>175</sup>, however, while there is majority support in Japan, South Korea and Singapore, only minority support is indicated for China, Philippines, Vietnam, and Indonesia (Shin, 2005). Two further considerations are relevant in this context. First, inequality is generally more easily tolerated in an environment of rapid growth. If there were to be a slowing down of the rapid growth that East Asia has recently experienced, the current levels of inequality are likely to find lesser acceptance in the region. Second, even when relative inequalities are unchanged, absolute disparities widen with economic growth. For instance, Ravallion and Chen (2006) estimate that absolute Gini indices<sup>176</sup> in urban and rural China increased much more rapidly during 1981-2001 than the conventional relative-income Gini indices. As this translates into large differences in absolute standards of living, this can be an additional source of discontent and friction.

Second, inequality of income and wealth can turn into inequality of opportunity across generations. Estimates of intergenerational mobility are low even for developed countries (World Bank, 2005b). For developing countries in East Asia with their underdeveloped credit markets, they are likely to be lower still, leading to a reproduction of inequalities over time.<sup>177</sup> Thus, given the presence of credit market imperfections, even merit-based or

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<sup>173</sup> Empirical evidence on the relationship between growth and inequality remains rather inconclusive in terms of the direction of causality, whether the relationship is positive, negative or non-monotonic, as well as the mechanisms underlying the relationship; for a range of differing results, see for instance, Barro (2000), Bannerjee and Duflo (2003), Voitchovsky (2005).

<sup>174</sup> Similarly, Han and Whyte (2006) report that 72% of over 3000 Chinese adults surveyed in 2004 either “strongly agreed” (40%) or “agreed somewhat” (32%) that inequality in the country as a whole is “too large.”

<sup>175</sup> Market capitalism refers to norms relating to (i) private ownership of business and industry, (ii) competition in the marketplace, (iii) unequal distribution of income as incentive for individual striving, and (iv) individuals’ responsibility for their own welfare (Shin, 2005).

<sup>176</sup> Absolute Gini indices are calculated by normalizing income differences by fixed mean income at a particular date.

<sup>177</sup> From a theoretical perspective, Fender and Wang (2003) present an overlapping-generations model where credit constraints contribute to rise in inequality between the skilled and the unskilled through the channel of human capital accumulation. Empirically, using a measure of financial depth and inequality in the distribution of land as proxies for capital market development, Li, Squire, and Zou (1998) find capital

incentive-promoting income differentials can turn into inherited advantages or drawbacks, and inequality at one date may be reinforced or even widened over time.

A related concern arises from the growing evidence that inequality can hamper productive investments, especially in human capital.<sup>178</sup> As investments in human and physical capital are a crucial factor in determining household incomes, differential ability to invest in such capital affects the degree of income inequality.<sup>179</sup> In an environment of highly imperfect credit and factor markets, individual investments are often limited by individual endowments. Thus, the resource- and income-poor tend to under-invest which in turn limits their future income growth. This is consistent with the evidence that higher inequality tends to make growth less pro-poor.<sup>180</sup>

Fourth, high levels of inequality (especially when they overlap with ethnic or religious divisions) can be a source of political instability. As Figure 6.13 shows, countries with more (less) equal income distributions tend to have greater (less) political stability. There are indications of growing social unrest in some parts of East Asia. For instance, estimates cited by Gill (2006) indicate that the number of incidents of social unrest in China grew from 8,300 in 1993 to over 80,000 in 2005. While there are many underlying reasons for such unrest, spatial and other disparities related to the economic reform process appear to have been a factor (Keidel, 2005). Similarly, the rise of ethnic-based (Malay-Muslim) violence in Thailand's southernmost provinces (Narathiwat, Yala, and Pattani) since 2001 appears to be grounded in part in the absolute and relative deprivation of the local populations (Croissant, 2005). In the Philippines, while the Moro and communist insurgencies have been mostly concentrated in the Mindanao region, their effects have been felt throughout the country (in 91% of the provinces during 1986-2004). A recent analysis suggests that a contributing factor to the incidence of armed conflict in the country during 1986-2004 has been the disparity in access to basic infrastructure and services, especially reliable water supply, electricity, and education (Edillon, 2005). Such incidents of social unrest, in addition to their direct human cost, also have the potential of eroding popular support for economic reforms and more generally disrupting the process of economic growth.

To summarize, the existence of a certain degree of inequality is consistent with economic systems (increasingly typical of East Asian countries) that aim to reward higher individual effort, productivity, and innovation. As the data from the aforementioned World Values Survey indicate, there is a fair degree of social support in the region for such incentive-promoting inequality. However, from a normative perspective, the

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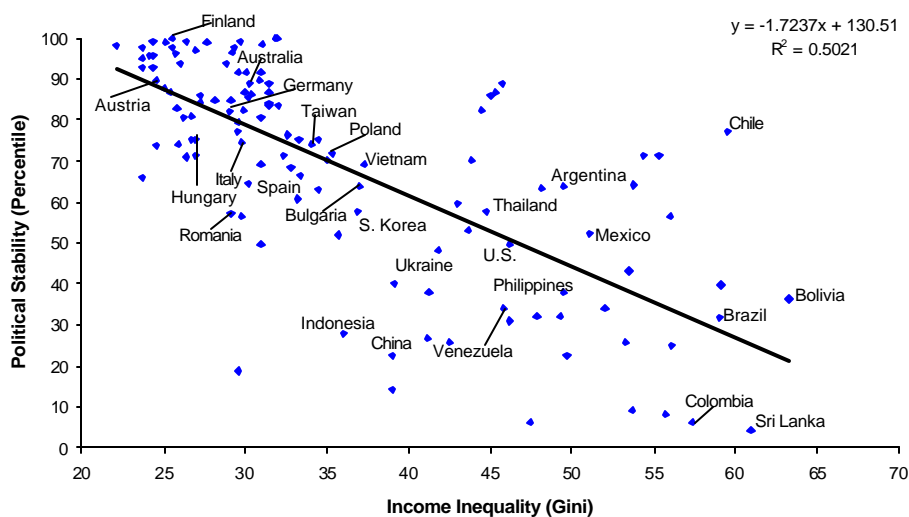
market imperfection to be an important determinant of international and intertemporal inequality across 49 countries spanning the period 1947-94.

<sup>178</sup> See World Bank, 2005b, especially chapter 5 for a review of such evidence.

<sup>179</sup> For instance, Wan and Zhou (2005) identified capital input as an increasingly significant determinant of income inequality in rural China. For similar evidence for urban and rural China as a whole, also see Zhang and Zhang (2003).

<sup>180</sup> For international evidence see World Bank (2005b); for evidence for China during 1981-2001, see Ravallion and Chen (2006).

**Figure 6.13: Political stability tends to decline with rising inequality (sample of 44 countries during 1996-2002)**



*Source:* World Income Inequality Database V 2.0a (June 2005); Kaufmann D., A. Kraay, and M. Mastruzzi (2005): Governance Matters IV: Governance Indicators for 1996-2004.

primary concern is with equality of opportunity, and hence with the need to ensure that income and wealth differences do not translate into highly unequal opportunities across society. At a more pragmatic level, a key concern is that levels of inequality do not threaten social and political stability that is not only important in its own right but is also necessary for sustaining growth.

## 6.5 Addressing spatial and social disparities

While East Asia's record of poverty reduction over the past two decades has been enviable, the foregoing discussion indicates that the issue of disparities across people, sectors, and regions is becoming increasingly important. Large disparities—in terms of income as well as human development—persist, and in many instances they have grown. This chapter discussed several underlying forces contributing to the observed patterns, including the role of trade and globalization, labor market reform, growth of clusters and agglomeration economies, fiscal decentralization, and internal migration. As many of these underlying forces are likely to persist during the next phase of growth, equity in countries of the region is a growing concern. The discussion highlights that many of the same forces that have helped augment growth in the region have also contributed to these disparities.

It is also reasonable to expect that these forces will continue to unfold in the foreseeable future. Greater openness to trade and investment, international production and distribution networks, dynamic urban clusters building on agglomeration economies, reform of the labor markets in transitional countries, migration and the process of decentralization—these trends are all well-established in the region, and unlikely to be

reversed. Hence, looking ahead the policy challenge for the region is how these processes can be managed so as to reap the benefits in terms of growth (and poverty reduction) while keeping disparities in check so to maintain overall social cohesion that is necessary (though not sufficient) for sustaining the growth process itself. From this perspective, this concluding section draws out the emerging implications for public policy in the region in the following areas.

- *Investments in human capital.* Increasing rates of return to education and rising skill premia raise private incentives to acquire higher education. Hence, some of increase in wage dispersion may be viewed as transitional, which could be reversed as people invest more in their human capital enabling them to make better use of the opportunities created by economic growth. However, in an environment of imperfect credit markets, individual investments are typically constrained by individual endowments, which thus points to an important role here for public policy. Moreover, the social return to human capital investment is even higher than the private return as there are important spillover effects of human capital in improving the absorption of new ideas and technology, enhancing adaptability to changing configuration of new opportunities, and promoting innovation systems. While East Asia made big strides in primary education over the last two decades, enrollments at secondary and tertiary levels remain relatively low in many countries, and there are large disparities within countries. Policies to promote wider and more equal access to higher education, which will almost certainly require greater public investment, will be critical not only for the next phase of growth in the region but for also ensuring that this growth is more equitably distributed.
- *Facilitating migration.* Internal migration has the potential of being an important equalizing force within countries in addition to its contribution to growth, which is already being realized in several countries in the region. However, the existing large differences in rural-urban as well as cross-regional wage and income levels indicate that there remain continuing impediments to labor mobility. These include the low human capital base of potential migrants, *de facto* restrictions on the movement of people across regions, and access to basic services (education of children, housing, and health) for migrants in destination areas. Public policy to alleviate such impediments will be important to realize the potential of migration in contributing to more equitable growth.
- *Investment in lagging regions.* However, moving people to jobs will not be enough. At least in the medium term, this will need to be supplemented with policies to support greater job creation in the lagging areas through investments in physical and social infrastructure and measures to improve investment climate in smaller cities, so that growth clusters beyond the current set of dynamic urban agglomerations can be developed that can offer off-farm employment opportunities to rural populations. This will require some rethinking of the role of industrial policy during the next phase of growth in the region.
- *Developing credit markets.* An additional policy area relevant to both physical and human capital investment as well as migration is credit market development. The financial constraints faced by poor households often inhibit them from taking

advantage of income-generating opportunities offered by the process of economic growth. Thus, alleviating impediments to access to credit for the poor can go a long way in supplementing public investments to promote a more equitable distribution of the benefits of economic growth.

- *Development of social protection systems.* Greater economic integration has increasingly tied the fate of people in East Asia to changes in the world and regional economy, thus exposing populations to new sources of vulnerability. One important lesson of the East Asian crisis relates to the weaknesses it exposed in the existing social protection system in region. The coverage of the formal social protection systems still remains very limited in most countries while demands have risen with growing urbanization and migration, and an aging population in several countries. Improving the coverage and performance of unemployment insurance, health insurance, and pension systems as well as targeted income-transfer programs, is likely to assume greater importance in the future.
- *Promoting greater fiscal equalization.* While the ongoing process of decentralization faces many challenges, addressing large fiscal disparities in the system will be important for ensuring a more equitable distribution of public services, especially in education, health and upgrading of local infrastructure. Current inter-governmental transfer systems will need to rebalance greater horizontal equalization against the goal of maintaining optimal fiscal incentives for local governments. However, provision of greater resources to poorer areas in itself will not be enough, and building adequate channels of accountability at different levels of government will continue to be an important challenge.

These observations are inevitably rather broad in character. However, one must not lose sight of the fact that the region comprises a diverse group of countries which—despite their shared experience of rapid growth over the last decade or more—still remain at very different stages of development. And hence, the nature of specific policy challenges and options for addressing the above priorities in different countries will vary with their level of development. The above discussion nonetheless suggests that there may well be some short-term trade-offs between promoting greater growth and more equity. However, trading off a little bit of growth for more equity in the design and implementation of future public policies is likely to be good for long-term growth as well as equity and social cohesion in the region.

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