Evidence of rising inequality in Asia poses challenge

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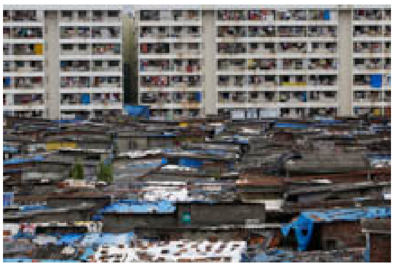
By the late 20th century, it was widely believed that GDP growth was more likely to enhance living conditions for the majority (including the poor) than battles over income distribution. However, the notion that the benefits of GDP growth in market economies automatically 'trickle down' has been called into question by a key global trend that has emerged over the last four decades: rising inequality despite strong GDP expansion. This is particularly true for Asian economies, which have seen robust growth in recent decades.



High rise residential buildings are seen behind a slum in Mumbai (Reuters/Danish Siddiqui)

What next

In coming decades, real wages will need to rise in tandem with increases in productivity to support healthy aggregate demand growth. A prolonged divergence of the two trends, with either wages lagging or over-shooting productivity gains, threatens not only social and political stability, but also economic growth and financial stability.

Impact

- The middle class in developing Asia will increase demands for progressive tax policies and improved services delivery.
- However, reforms will be incremental and uneven, with countries such as India seeking to attract investors with lower taxes.
- Closing the gap in skills would be key to reducing income inequality.

Analysis

Economists often use the Gini index, based on the distribution of household incomes, to measure the degree of economic inequality in a country. The scale ranges from one to zero, with one referring to absolute inequality and zero to absolute equality. Countries with Gini index of over 0.4 are regarded as unequal. While this measure faces strong criticisms -- particularly with regard to measurement problems for data such as non-wage benefits -- mounting concerns about inequality mean that the Gini index cannot be ignored.

Gini index

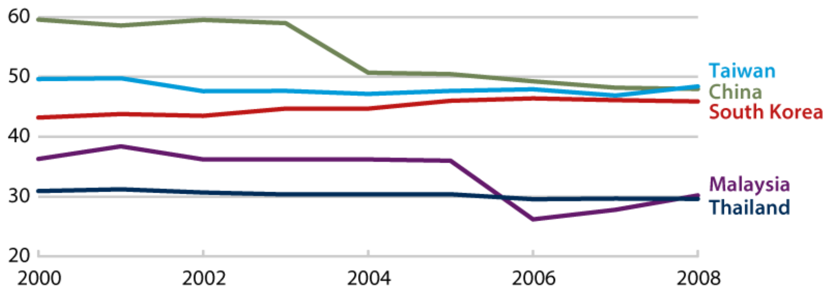
Accordingly to a 2012 Asian Development Bank (ADB) report, 13 of 36 Asian economies had Gini coefficients of 0.4 and above, and eleven economies -- covering 82% of Asia's population -- appear to have experienced worsening inequality:

- These include Singapore (0.47), China (0.51), Malaysia (0.46), the Philippines (0.43), India (0.40) and Pakistan (an estimated 0.68) among others.
- In many cases this index has risen sharply -- for example China has seen an increase from about 0.30 in the early 1990s.

11 of 23 Asian economies seem to be experiencing widening inequality

Among developed-world countries, the United States -- with Gini of 0.46 -- stands among the more unequal societies, whereas Japan and leading European countries report Ginis of 0.25-0.35.

Functional income distribution



Labour Share (% of GDP)
Sources: ILO, Bank of Korea, Taiwan Directorate General of Budget, Shymala and Goh, Thai National Economic and Social Development Board

An arguably more revealing, but less used, measure of economic inequality is functional income distribution, ie, the proportion of labour (wages and benefits) and capital (profits, rents and interest) in a country's GDP. According to the ILO, the labour share of GDP in four of five selected Asian countries (China, South Korea, Taiwan, Malaysia and Thailand) has declined over the last two decades:

- In China, it has dropped steeply from 60% in 1995 to 48% in 2008.
- In Taiwan, it has fallen from 54.1% in 1990 to 48.4% in 2008.
- In Malaysia it fell from 36.7% in 1991 to 30.2% 2008.
- Even in South Korea, which has a relatively low Gini index, the labour share of GDP has ranged from 48% to 43% between the early 1990s and the late 2000s.

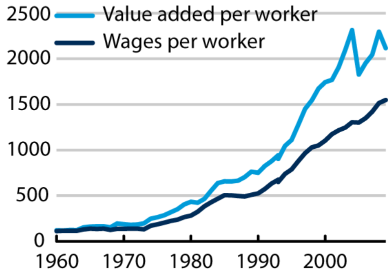
Drivers of inequality

Technology favours workers with higher levels of education and skills, and hence the income gap between skilled and less skilled labour widens. Indeed, countries have become very conscious of the competition for global talent. However, there are other important factors, chiefly global financial integration and expansion in world trade, that have encouraged relocation of production, particularly since 1990. This weakened the bargaining power of labour (especially unskilled labour) in many less developed as well as developed countries:

Real Wages and Productivity Indices, China
Source: CEIC

- The entrance of millions of unemployed or underemployed (often agricultural) workers in previously peripheral regions such China, India and South-east Asia into the global workforce facilitated the global arbitrage of labour.
- Many Asian countries compete for foreign investments by repressing unions and wages, which puts a brake on wage demands in both poor and richer countries.

So far, this has continued to weaken labour's bargaining power globally, as reflected in the rise of temporary and contract labour and stagnating or declining wage income. As a result of these forces, wage growth has not kept up with the rise in labour productivity in many countries.



Wages & Productivity in Manufacturing Sector, Malaysia
Source: CEIC

Consequences

The consequences of rising economic inequality are multi-faceted:

Instability

Long-term divergence between productivity and wage growth could threaten social and political stability. The ADB undertook a survey of over 500 national policymakers in Asia in 2012 and found that 95% of respondents felt it was important to adopt policies to prevent a further rise in inequality in order to maintain political stability and economic growth.

Unsustainable growth

According to recent IMF reports, inequality hampers long-term growth. While it is possible to experience periods of high growth irrespective of inequality, the Fund argues that income distribution is one of the most robust predictors of the sustainability of growth. Furthermore, extreme inequality tends to misallocate human resource development and is often associated with weak institutions and governance.

Inequality is bad for long-term growth

Financial instability

Inequality may contribute to financial instability. For example, the declining share of wages in China's GDP may have contributed to:

- the reported drop in the share of personal consumption (from over 50% to 35% of GDP in the last four decades according to official figures);
- the concomitant rise in the savings rate (from about 30% to over 50% of GDP); and
- a large current account surplus.

During the last 15 years, China's excess savings were increasingly recycled through the international financial system and helped fund the debt-driven rise in US consumption (which reached 72% of GDP in 2007), thus contributing to the boom that ended in the 2007-08 bust.

Asset bubbles

Wages are not just a cost factor in economic growth; they are also an important driver of aggregate demand. If wages are repressed, then aggregate demand and growth are negatively affected absent compensating mechanisms (such as debt). However, debt-financed consumption carries risks, as amply demonstrated by the US financial crisis. A number of Asian countries are exhibiting similar tendencies (see SOUTH-EAST ASIA: Risk of asset bubbles is on the rise - April 4, 2013). In South Korea and Malaysia, where the wage share in GDP is declining due to wages falling behind productivity growth, household consumption and debt have been climbing:

- Household debt to GDP was 89% in South Korea and 75% in Malaysia in 2010.
- Even more alarming, household debt to disposable income was 164% in South Korea (2012) and 140% in Malaysia (2010).

Although there may be some offsetting factors -- such as possibly underestimated household incomes in these countries -- there are reasons to be concerned given the risks posed by debt-driven consumption and, behind this, rising inequality and a declining wage share.

Poorly targeted spending

In the past three decades, government policies in many countries have favoured competitiveness through reductions in corporate taxes and public spending. Consequently, resources for public investment have been reduced and welfare spending has been channelled through politically expedient but financially unsustainable measures such as the rice pledging scheme in Thailand and the food bill in India (see INDIA: Congress pins hopes on flawed food bill - July 10, 2013).

Absent a change in government policy or a 'trickle down' of the benefits of GDP growth and technological advancement, political, social and economic risks posed by inequality will mount.