

RESEARCHERS AT SINGAPORE'S *INSTITUTE OF SOUTHEAST ASIAN STUDIES* SHARE THEIR UNDERSTANDING OF CURRENT EVENTS

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### **Taking the Income Gap in Southeast Asia Seriously**

*By Aekapol Chongvilaivan*

#### **SUMMARY**

Although Southeast Asia has experienced a fast pace of economic development, it has increasingly become apparent that the benefits of growth in the region are by and large unevenly distributed. The key message of this ISEAS Perspective is that Southeast Asia, to date, has succeeded in boosting income per capita, notwithstanding unending economic uncertainties in the U.S. and the euro zone. However, the buoyant picture has mostly been plagued by remarkable rises in income inequality. Gains from economic advancement are unevenly distributed toward the high-income groups, whereas incomes for the low-income groups have been considerably slower. In addition, there are at least three main structural drivers of rising inequality in the region. These are economic growth; trade openness and liberalization; and financial market development. At the same time, analyses point to policy options that allow the region to thrive on inclusive growth such as enhancing and equalizing access to education; incorporating inclusion and equity into economic strategies; improving governance and institutional quality; and rebalancing public spending on social protection.

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## INTRODUCTION

Although the economies in Southeast Asia have exhibited exceptional performance, development between the countries is largely uneven, and the emerging disparities pose critical challenges to inclusive and sustainable growth. There are quite a number of reasons for this which necessitates a new phase of policies and reforms that enhances inclusive growth.

First, disparities necessitate redistributive policies and interventions which fundamentally distort resource allocation and may practically entail inefficiencies in terms of poor administration and corruption. Second, inequality constitutes a root cause of socio-political instability and violence, which have become evident in many parts of Asia. Unrest arising from disparities is therefore detrimental to the growth trajectory of a country. Third, concentration of wealth and economic resources to small groups is eventually translated into inadequate market size and small aggregate demands that undermine the competitiveness of an economy. Finally, inequality entails misallocation of investment because rising inequality necessitates substantial social investment, especially in human capital and institutional infrastructure, ultimately hampering economic growth.

Therefore, given the undesirable effects of inequality, tackling escalating inequality holds the key to inclusive, sustainable growth in Southeast Asia. If left unattended, steady growth will soon reach its limit, and risk undoing the progress the region has achieved.

What is the current state of inequality in Southeast Asia? What are its driving factors? What needs to be done to mitigate disparities? This *ISEAS Perspective* attempts to answer these questions. The analysis points to a set of policy options that aim for inclusive growth, including enhancing and equalizing access to education, incorporating inclusion and equity into economic strategies, and rebalancing public spending on social protection.

## RECENT TRENDS

**Table 1: Current Levels of Income Inequality in ASEAN.**

Country	Year	GINI (%)	Theil T <sup>a</sup>	Theil L <sup>a</sup>	MLD
Cambodia	2007	44.37	0.338	0.301	0.252
Indonesia <sup>b</sup>	2009	37.11	0.225	0.212	0.227
Lao PDR	2008	36.74	0.223	0.206	0.226
Malaysia	2009	46.21	0.348	0.357	0.372
Philippines	2006	44.04	0.318	0.310	0.323
Thailand	2004	42.45	0.298	0.282	0.300
Vietnam	2008	37.57	0.231	0.218	0.231
China <sup>b</sup>	2005	34.80	0.193	0.190	0.209
India <sup>b</sup>	2004	37.59	0.231	0.218	0.233

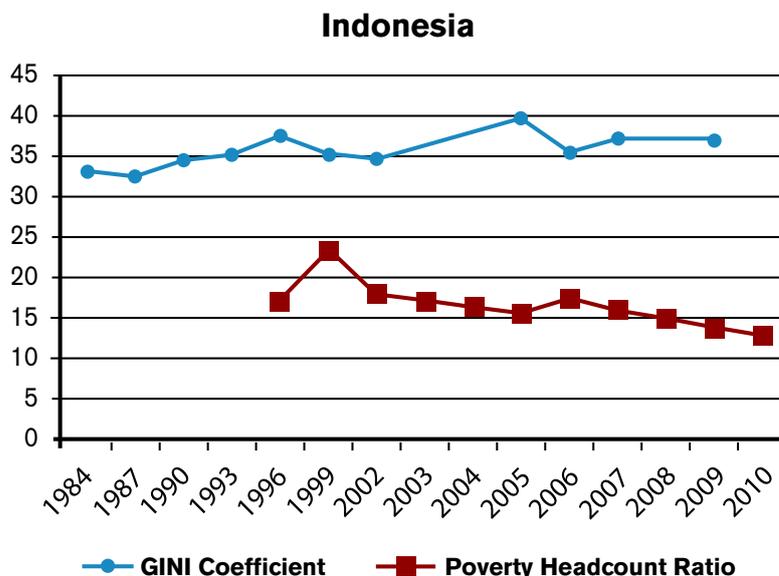
Source: Author's calculation based on *PovCalNet*, the World Bank.

Note: a) Calculation is based on distribution of income deciles; and b) Data are based on income distribution in urban areas.

Among Southeast Asian countries, Malaysia's income distribution is the most uneven, with the four indices taking the highest values: 46.21 percent for the GINI coefficient, 0.348 for Theil *T*, 0.357 for Theil *L*, and 0.372 for MLD.<sup>1</sup> Income inequality in Cambodia, the Philippines and Thailand is comparable to Malaysia's as their values of the inequality indices are somewhat lower. Interestingly, the widening income inequality in these countries is more alarming than that in China and India. Income inequality in Indonesia, Lao PDR, and Vietnam is less pronounced than neighbouring countries in Southeast Asia and is on a par with China and India.

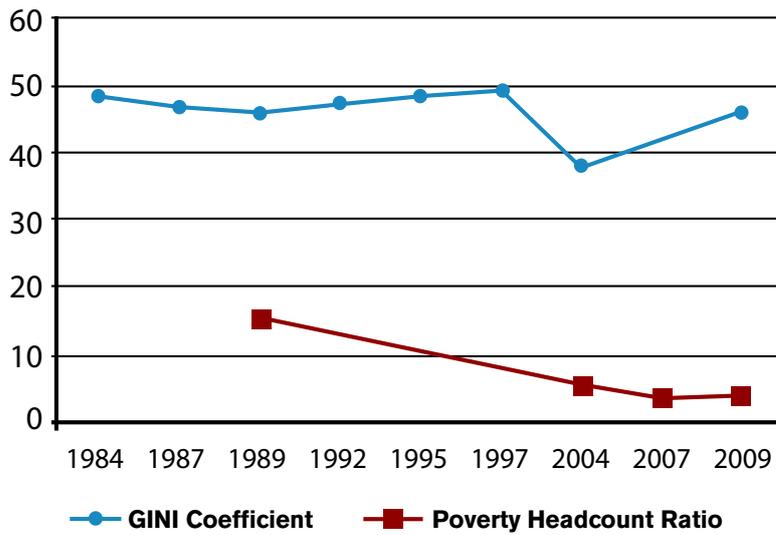
Figure 1 portrays the trends of income inequality and poverty at the national level in four Southeast Asian countries: Indonesia, Malaysia, the Philippines, and Thailand. The accelerated poverty reduction accompanied by rising income inequality is particularly discernible in Indonesia and the Philippines. In Malaysia and Thailand, the substantial plunges in poverty have been coupled with slight drops in income inequality since the 1980s, even though the GINI coefficients exhibit some spikes in the aftermath of the Asian financial crisis for Thailand and in the run-up to the global financial crisis in 2008-9 for Malaysia. This pattern of change implies that rising inequality in Southeast Asia is driven primarily by the extent to which incomes of the rich surge at a faster pace than those of the poor, and is thus in contrast to other regions like Sub-Saharan Africa and South America, where the rich exclusively take in the benefits of economic growth while the poor are left behind and remain poor, if not even poorer. This also highlights that in Southeast Asia, gains from swift economic development are being shared inequitably.

**Figure 1: GINI Coefficient and Poverty Headcount Ratio at National Poverty Lines (percent).**

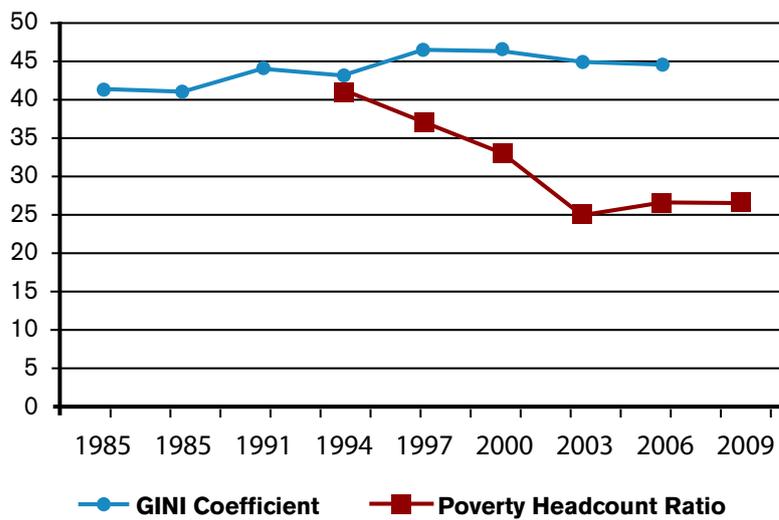


<sup>1</sup> The four measures – the GINI coefficients, Theil's indices (henceforth Theil *T* and Theil *L*) and the mean log deviation (MLD) – are calculated by the World Bank's PovCalNet database which constructs the proxies of income inequality based on the household-level data. It should be highlighted that the higher values of these measures represent higher degrees of income inequality. The measurement of Theil's indices and MLD is relegated to Appendix.

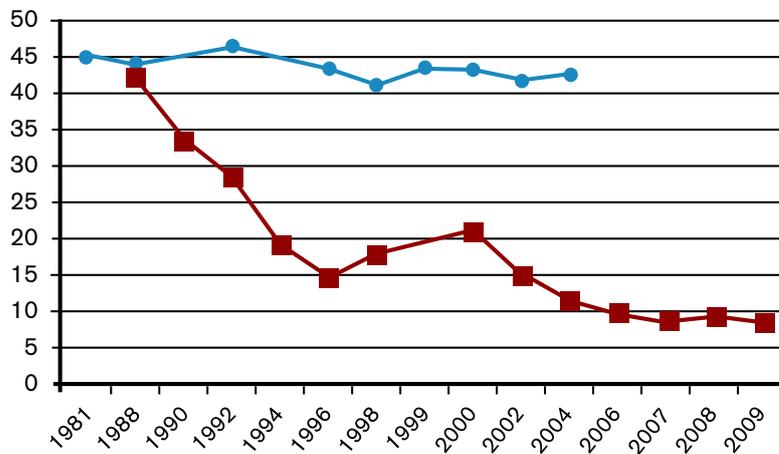
### Malaysia



### Philippines



### Thailand



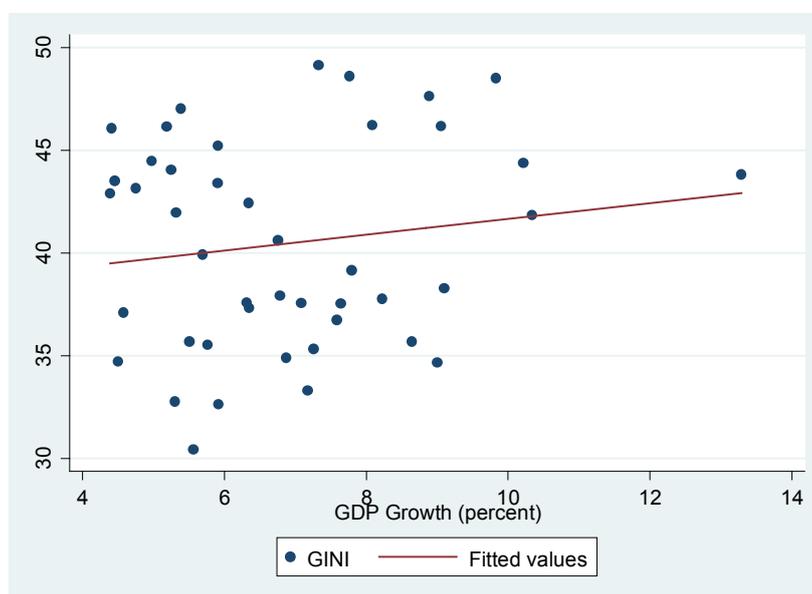
Source: PovCalNet and World Development Indicators, the World Bank.

The trend in Indonesia is rather fluctuated. Income inequality has gradually escalated since the late 1980s; however, the aftermath of the Asian financial crisis witnessed a sudden plunge in income inequality even though it soon bounced back after 2002. Inequality in Indonesia rose rapidly during 2002-5 and experienced another plunge in 2006. In 2009, inequality in Indonesia slightly improved from the level in 2007. In Malaysia, the GINI coefficients gradually escalated during the late 1980s, followed by a drop in the aftermath of the Asian financial crisis during 1997-2004 and a widening trend in the run-up to the global financial crisis in 2009. In the Philippines, income inequality had substantially deteriorated during 1985-1997; nevertheless, the trend of rising inequality reversed thereafter. In the aftermath of the Asian financial crisis, the Philippines managed to achieve a consistent drop in the GINI coefficients. Income inequality in Thailand has reduced vaguely since 1990s, notwithstanding a considerable spike in the aftermath of the Asian financial crisis in 1998-2000.

## STRUCTURAL DRIVERS

### ECONOMIC GROWTH

**Figure 2: Income Inequality and Economic Growth in ASEAN.**



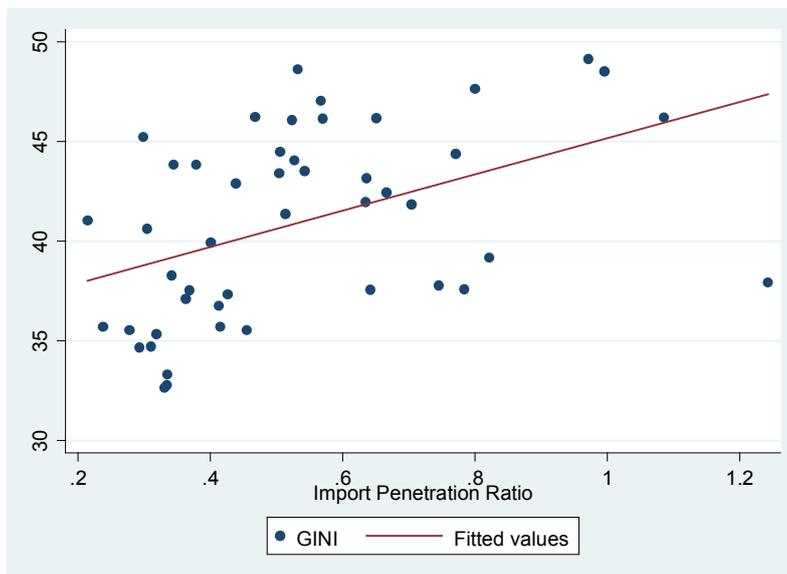
Source: Author's calculation based on the World Bank's PovCalNet and World development Indicators (WDI).

Note: Country samples include: Cambodia, Indonesia, LAO PDR, Malaysia, the Philippines, Thailand and Vietnam, in various years.

Figure 2 presents a scattered plot of the GINI coefficients and GDP growth in seven Southeast Asian countries during the period 1981-2009, including: Cambodia; Indonesia; Lao PDR; Malaysia; the Philippines; Thailand; and Vietnam. It can be observed clearly that GDP growth is positively associated with the GINI coefficients, implying that economic development inculcates widening economic inequality in the region. Over the past three decades, industrialization strategies have been switched from export-orientation and, to a lesser extent, import-substitution growth, towards capital deepening. This policy shift was coupled with a sharp surge in capital inflows, mostly from Japan and the US, into the region, and forced structural adjustments toward capital-intensive industries like electronics and automobile industries, and ultimately took in capital accumulations as a crux source of growth in Southeast Asia. As suggested by the Kuznets hypothesis, this pattern of growth is prone to reward owners of land and capital – a small group of economic agents in an economy – instead of labour, and will aggravate inequality in Southeast Asia.

## TRADE OPENNESS AND LIBERALIZATION

**Figure 3: Income Inequality and Trade Openness in ASEAN.**



Source: Author's calculation based on the World Bank's PovCalNet and World development Indicators (WDI). Note: Country samples include: Cambodia, Indonesia, LAO PDR, Malaysia, the Philippines, Thailand and Vietnam, in various years.

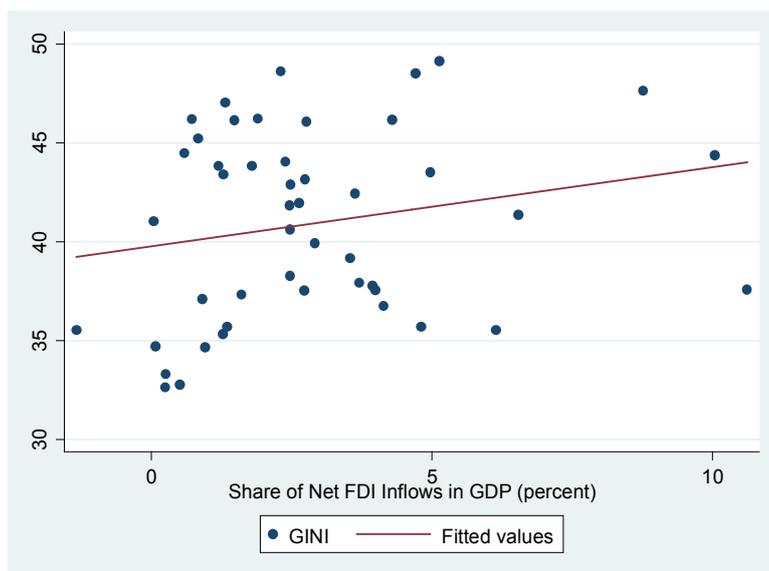
Another root cause of the rise of economic inequality in Southeast Asia pivots around the consequences of policies that advocate trade liberalization. The past three decades witnessed remarkable reductions of tariff rates and non-tariff barriers, such as quotas and

anti-dumping duties on top of unprecedented increases in openness and exports. As a matter of fact, a path toward free trade is typically followed by domestic policy changes that exacerbate inequality. For instance, proliferating FTAs among ASEAN member countries have often been accompanied by clauses related to enhancing the movement of skilled labour which is naturally more mobile, and thus further liberalization may be in favour of skilled labour rather than unskilled labour. Likewise, the establishment of industrial parks to build up the competitiveness of some sectors like the automotive and electronics sectors and to make Southeast Asian countries attractive to foreign investors has by and large concentrated on the location where capital and infrastructure are abundant.

Figure 3 presents preliminary evidence that trade openness in Southeast Asia may aggravate inequality. The positive correlation between trade penetration and the GINI coefficients is in contrast with the exposition by the standard trade theory that developing countries stand in good stead to leverage on bridging disparities as the countries reallocate resources toward labour-intensive and unskilled production, thereby shifting the relative demand for unskilled labour. In developing Southeast Asian countries where unskilled workers are in abundance, gains from trade appear to be more pronounced for the high-income group than the low-income one.

## FINANCIAL MARKET DEVELOPMENT

**Figure 4: Income Inequality and Financial Market Development in ASEAN.**



Source: Author's calculation based on the World Bank's PovCalNet and World development Indicators (WDI). Note: Country samples include: Cambodia, Indonesia, LAO PDR, Malaysia, the Philippines, Thailand and Vietnam, in various years.

As with trade liberalization, the effects of financial sector development that substantiates cross-border movement of capital remain controversial. On the one hand, domestic financial deregulation helps perk up resource allocation and returns on financial assets by channeling capital to the most efficient uses. The rise in income accrued by the holders of financial assets can potentially be redistributed to put forward equitable economic development. Financial sector development, on the other hand, can exacerbate the distribution of income in developing countries in various ways. First, the appreciation of domestic currencies as a result of an enormous influx of capital inflows may divert resources away from low skill-intensive sectors and trigger a plunge in demand for unskilled workers. Second, undue development towards a free capital market puts countries at risk of financial crises in which the poor are the most affected. The 1997 Asian financial crisis offers an exceptional example of how the gratuitous, impulsive liberalization of financial sectors ultimately propelled millions of the poor into poverty, thereby widening inequality in the region. Finally, the problems of incomplete information, herd behavior, weak supervision, excessive speculation and inadequate institutional infrastructure plague the well-functioning liberalized international financial system, and thus the real effects of financial market reforms on inequality are adverse.

Figure 4 portrays a scatterplot of the GINI coefficients and the shares of FDI inflows into the Southeast Asian countries in GDP as a proxy of financial sector development. The share of FDI inflows in GDP appears to be positively correlated with the GINI coefficients, suggesting that financial market development and liberalization have been a catalyst of rising income inequality. The worsening distributive effects associated with financial sector liberalization can be explained by the fact that the high-income groups which typically own financial assets stand to take in the upside gains in terms of higher rates of return while the poor tend to bear the downside losses in terms of destabilizing speculation and crises, a downward shift of relative demand for unskilled labour as a consequence of resource reallocation, and the arising caveats and incompleteness of financial reforms.

## **POLICY OPTIONS**

### **OPTION 1: ENHANCING AND EQUALIZING ACCESS TO EDUCATION**

Equitable access to education holds a key to bridging income inequality, suggesting that overall inequality tends to plunge significantly should income differentials across different levels of education be eliminated. Even though several basic human development indicators in the region such as literacy rates and primary school enrolment are quite satisfactory and comparable to those of developed countries, most Southeast Asian countries are apparently lagging behind developed countries in terms of higher education development, particularly universities. An explanation is perhaps that in most ASEAN countries, primary education is largely generalized, thereby limiting private returns to education. That said, the problem is not inadequate access, but is instead the quality of education at the primary level. In addition, public spending on education should put more emphasis on ensuring

equal access to higher education, especially at the secondary and tertiary levels, as well as sufficient graduates with technical skills like science and technology. The rationale is that higher education essentially augments labour productivity and enables low-income groups to catch up, ultimately reducing income differentials in a country.

## **OPTION 2: INCORPORATING INCLUSION AND EQUITY INTO GROWTH STRATEGIES**

In Southeast Asian countries, inclusion and equity have not been sufficiently emphasized. The shift of growth policy toward export orientation and market-driven regimes fails to embrace inclusion and equity. The striking economic development and poverty reduction in the region have been achieved at the cost of widening inequality. Even though much research affirms that these outward-looking strategies have helped bolster rapid economic advancement in the region, these policies and reforms inherently spawned exclusion and inequality in the region. If this trend continues, it is self-evident that the region will soon exhaust its economic potential and sustaining the pace of economic development that the region once achieved will not be possible.

Southeast Asia is at the critical juncture when inclusion and equity need to be incorporated into every step of economic development. Inclusive growth, however, is easier said than done. Although recent developments in most ASEAN countries showed encouraging signs in terms of intensive investment in human capital and public infrastructure and growing public spending on social protection programs, it appears that the region is lacking equal opportunity which allows everyone to fairly take part in the development process and take advantage of economic growth. Unequal access to opportunity is partly due to the institutional and cultural factors whereby policies and reforms are typically in favour of those with economic and political influence. Ironically, redistributive policies and social transfers have been abused to uphold political support and power without significant impact on redistribution. Therefore, inclusive growth that encompasses every aspect of equitable access to opportunity for all will not be viable without a strong commitment to inclusion and equity, especially at the policy-making level.

## **OPTION 3: REBALANCING PUBLIC SPENDING ON SOCIAL PROTECTION**

Tackling swelling inequality in Southeast Asia requires government intervention. However, evidence indicates that for the time being, public spending on social security programs has zeroed in on investment in human capital, e.g. education and training, which provides equitable opportunity especially for the poor to pick up the right skills for higher-paying jobs and raising income. Even though the pivotal role of adequate human capital in bridging disparities is beyond doubt, the imbalances of public spending on social protection programs caution that resources are insufficiently allocated to other social safety nets and redistributive policies.

There are at least three avenues of social expenditure that are equally important but appear derisory in many Southeast Asian countries. First, labour market policies and programmes aiming to provide employment and unemployment benefits and insurance against

work-related risks such as illness, disability and accidents deserve greater coverage. In most Southeast Asian countries, these work welfares are largely limited, if not absent, even though they are most needed by the truly vulnerable. Additionally, health-related social protection programmes constitute another platform for strengthening social protection, such as subsidized health services, family allowances, and child development schemes. On the one hand, government provisions and subsidies of these services help reduce household expenditure on healthcare especially among the poor families. The health protection programmes, on the other hand, essentially build up labour productivity and human capabilities as do expenditures on education and training. Lastly, public housing schemes comprise a crucial part of social safety nets. In rural areas, ownership of arable land matters for lifting the income level among poor households since it serves as a source of food production. Likewise, in urban areas, public housing accounts for the improvement of standards of living for the poor and savings through lower housing costs can be set aside for consumption on food, healthcare, and education.

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## Appendix

Two types of Theil indices are conventionally utilized: Theil  $T$  and Theil  $L$ .<sup>2</sup> The former captures a transformation from income shares into population shares and can be expressed as:

$$T = \sum_{i=1}^n y_i \ln(y_i / p_i) \quad , \quad (1)$$

where  $y_i$  is an income share of a country  $i$  in a group of  $n$  countries, and  $p_i$  is a population share of a country  $i$  in a country group. Likewise, the second Theil index of inequality, denoted by  $L$ , follows the same idea with the reversed direction – a transformation from population shares into income shares. It can be written as:

$$L = \sum_{i=1}^n p_i \ln(p_i / y_i) \quad , \quad (2)$$

As is well known, the values of Theil indices are bounded in a range between nil and  $\ln(n)$ , where nil represents complete equality and  $\ln(n)$  points to complete inequality.

The mean log deviation (MLD) can be calculated by the mean across the population of the log of the overall mean divided by individual income. In the same manner as GINI coefficients and Theil indices, the higher values of MLD can be interpreted as greater income inequality.

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<sup>2</sup> Some caveats apply. First, Theil measures of inequality based on information theory is rather normative and thus in contrast to other alternative concepts like the Lorenz Curve. Additionally, the levels of inequality under Theil's measurement are influenced by a member with higher income.