

ADB

Inequality in Asia

KEY INDICATORS 2007 SPECIAL CHAPTER

HIGHLIGHTS

Asian Development Bank

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Inequality in Asia

1. Introduction

The development experience of Asia between the 1960s and the 1980s has typically been characterized as one in which one group of economies grew rapidly (the four “newly industrializing economies” of East Asia followed by several economies of Southeast Asia), while another group did not (the economies of South Asia). Low levels of income inequality appeared to characterize both groups of economies (with exceptions) in comparison with developing countries in other regions, especially Latin America. Since at least the 1990s, high rates of economic growth have become more common in the region. However, it is widely believed that inequalities have also grown in many countries.

How correct is this perception, and how broadly does it apply to a region as diverse as developing Asia? To the extent that inequalities have grown, what are its drivers? What are the implications for policy? These are questions that the special chapter of *Key Indicators 2007* addresses by considering recent data on inequality in incomes and, especially, consumption expenditures.¹ The Highlights present key findings of the special chapter.

2. Inequality in Asia: An Overview of the Evidence

Figure 1 presents estimates of the Gini coefficient, a popular measure of inequality. These estimates are based primarily on expenditure distributions for 22 developing member countries (DMCs) of the Asian Development Bank (ADB). (See Box 1 on some key conceptual and measurement issues relating to inequality.) A higher number

¹ Though other factors, such as educational and health status, political power, or access to justice, are important and contribute to economic well-being, our focus is on its distribution as captured through expenditure and income data.

Box 1 Conceptualizing and Measuring Inequality: Some Key Issues

The term inequality has many different meanings. In the special chapter, it is used primarily to describe how an indicator of economic well-being, as captured by data on income or consumption expenditures, is distributed over a particular population. Thus our focus is on income inequality, where the term income is a shorthand for inequality in either incomes or expenditures. Several issues relating to the conceptualization and measurement of inequality are useful to note.

Inequality: Absolute or relative? Should we measure inequality in terms of absolute dollar differences in incomes (for example, the dollar difference in average incomes of the top 20% versus the bottom 20%) or in relative terms (for example, the share of the top 20% versus bottom 20% in total income)? Absolute and relative inequality are fundamentally different concepts of inequality. While most economists prefer to analyze measures of relative inequality, many among the lay public think about distributional issues in terms of absolute inequality.

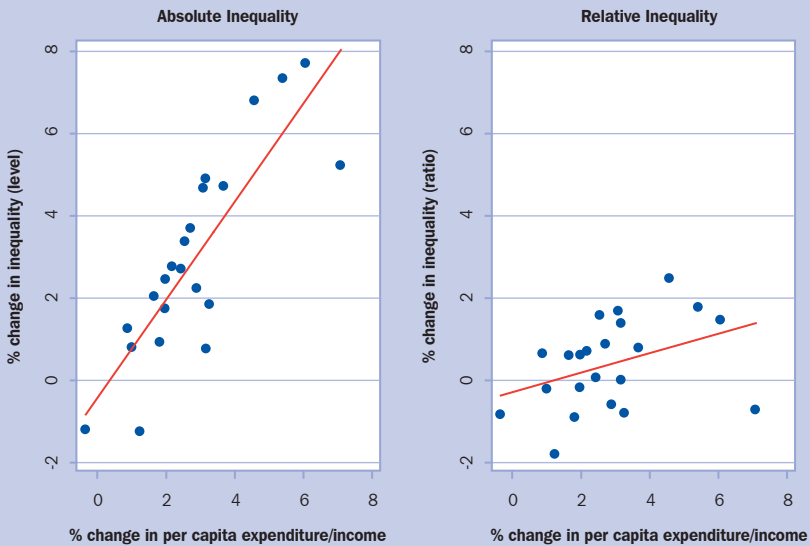
Box Figure 1 shows how economic growth has been correlated with growth in a measure of absolute inequality (left panel) and of relative inequality (right panel). As can be seen from Box Figure 1, economic growth is very closely associated with growth in absolute inequality. However, the association between economic growth and growth of relative equality is much weaker. Thus, which concept of inequality one uses can be of fundamental importance in determining how one sees inequality evolving in society at large, as well as in terms of its relationship with economic growth.

Measuring relative inequality. Two popular measures of relative inequality, which are used extensively in the special chapter, include the Gini coefficient, which ranges from zero (perfect equality) to 100 (perfect inequality); and the ratio of average incomes of the top 20% to bottom 20%.

Measuring “income”. The analysis of income inequality, a key focus of the special chapter, can be based on data on either incomes or consumption expenditures. Difficulties in collecting information on incomes reliably in developing countries—where agricultural employment and self-employment are important components of total employment—is an important reason for using data on the distribution of consumption expenditures across households to analyze income inequality.

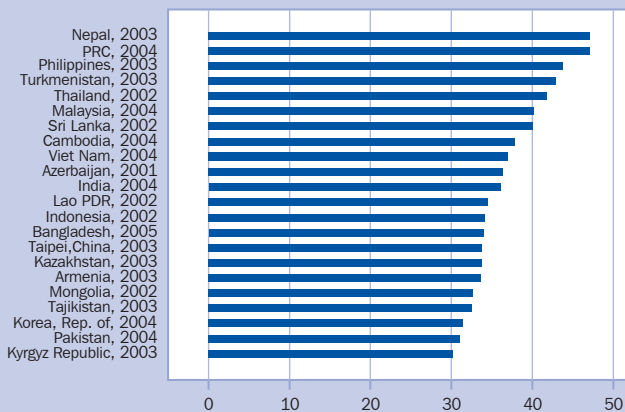
Household surveys. Nationally representative household surveys of incomes and expenditures are the main source of data for analysis of income inequality. While the quality of household surveys in developing Asia has improved, some issues deserve special attention. First, differences in survey design and questionnaires, both across countries as well as over time within countries, can be an important constraint on comparability of inequality estimates. Second, from the perspective of inequality analysis, approaches to better capture the incomes and expenditures of the rich are required. More practically, a failure to adequately capture the rich in household surveys underestimates both the extent of inequality and increases in it if richer households are seeing rapid increases in their incomes. Third, much more effort needs to be made in many countries in tracking the incomes and expenditures of a common set of households over time. Finally, public access to household survey data continues to be a major source of difficulty in some cases. For data to be able to guide policy, it is imperative that household survey data be put in the public domain, and as fast as possible once they have been gathered and validated.

Box Figure 1 **Inequality and Growth**



Note: 1. Both panels plot growth in mean income/expenditure (a proxy for economic growth) over the 1990s and 2000s for 21 DMCs against growth in a measure of inequality. In the left panel, the measure of inequality is absolute: the absolute differences in the 75th percentile and 25th percentile incomes/expenditures. In the right panel, the measure is relative: the ratio of the 75th percentile to 25th percentile incomes/expenditures. 2. In the regression of changes in (log) inequality on changes in (log) mean income/expenditure, the coefficient on growth of the mean is 1.20 when inequality is measured in absolute terms versus only 0.24 when inequality is measured in relative terms. Moreover, while the former coefficient is statistically significantly different from zero at the 1% level, the latter fails to be significant at even the 5% level (although it is significant at the 10% level).

Figure 1 **Gini Coefficients in Developing Member Countries (expenditure and income distributions)**



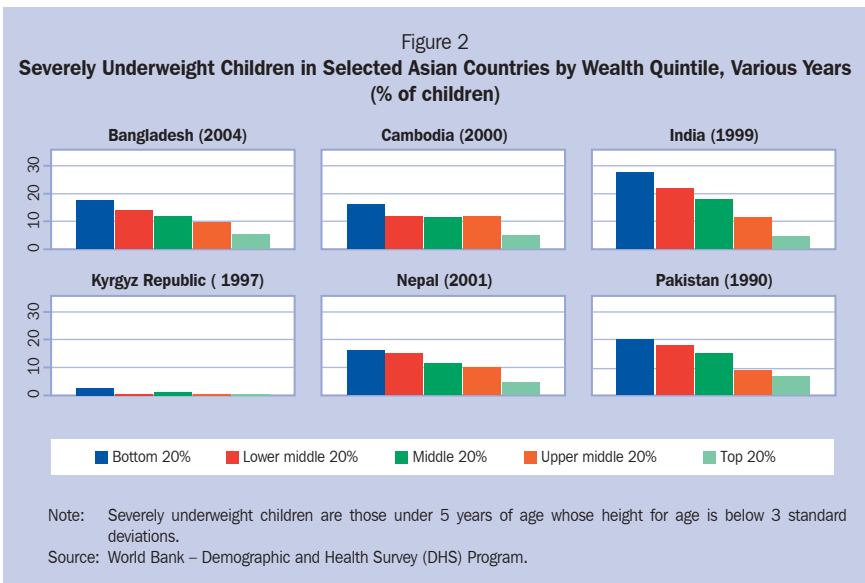
Notes: Per-household income distributions are used for Korea (urban wage and salaried households only) and Taipei, China. Per-capita expenditure distributions are used for the rest.

represents greater inequality. As the figure shows, seven DMCs have Gini coefficients of around 40 or more; the remaining DMCs have Gini coefficients of 30–40.

In the international context, these Gini coefficients may not represent particularly high levels of inequality, especially when compared to many Latin American and some sub-Saharan African countries, where Gini coefficients of 50 or more are common. This does not mean, however, that levels of inequality are low in developing Asia.

First, most of the Gini coefficients reported in Figure 1 are based on consumption expenditures. As international experience indicates, the use of consumption expenditures in place of incomes can be expected to lower estimates of inequality. In other words, Gini coefficients based on data on income distributions would show higher levels of inequality than Figure 1 indicates.

Second, inequality in incomes (or expenditures) represents only one dimension of inequality. Data on education, health, and economic assets such as land, however, can reveal inequality to be quite high even in those countries where income inequality is not particularly high. A stark illustration of this point can be seen from Figure 2, which depicts how severely underweight children are distributed across rich and poor households. As the figure reveals, both India and Pakistan—countries that do not register as having particularly high income inequalities—have very unequal outcomes on this measure of health status. In India, for example, around 5% of children are severely underweight among the richest 20% households. In the case of the poorest 20% households, this share is as high as 28%. The gaps between the rich and poor on this measure are much lower in Cambodia, a country with a higher Gini coefficient for expenditures. A similar pattern holds for the distribution of land—one of the most important economic assets in developing Asia. Thus, some South Asian countries, including India and Pakistan, rank fairly high in terms of the Gini coefficient

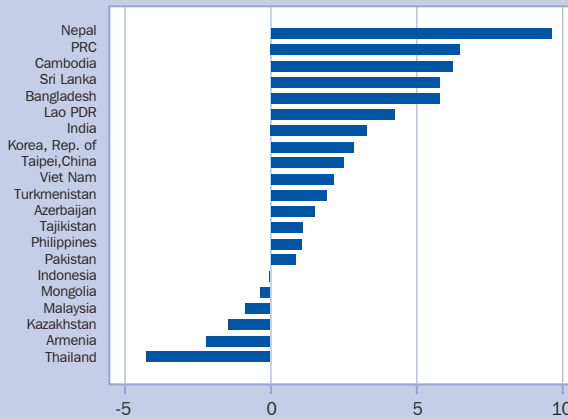


for land holdings. Once again, both of these are countries that do not have particularly high Gini coefficients for expenditures.

Third, even if we were to focus on income inequality in developing Asia, current levels represent increases in inequality over the last 10 years or so. This can be seen from Figure 3, which describes changes in the Gini coefficient for 21 DMCs over a roughly 10-year period (a little less or a little more in some cases). As may be seen, an increase in inequality is registered for a majority of the DMCs. In some cases, the increases are not very large (perhaps within the margin of statistical error). But in some DMCs, including some of the most populous, the increases in inequality are not trivial.

The increases in inequality are particularly sharp if we switch from measuring inequality in terms of the Gini coefficient (a measure of relative inequality), to a measure of absolute inequality. Indeed, underlying many of the cases of increasing Gini coefficients is a growth process in which those at the top of the distribution (top 20% here) have seen their expenditures/incomes grow considerably faster than those at the bottom (bottom 20% here). The differentials

Figure 3 Changes in Gini Coefficient for Expenditure/Income Distributions, 1990s–2000s (percentage points)

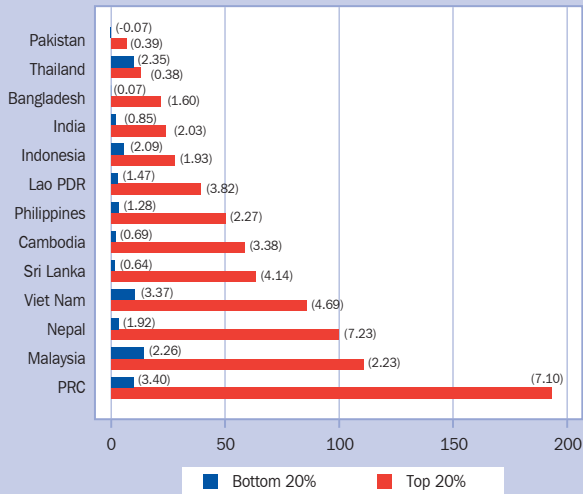


Notes: Years over which changes are computed are as follows: Armenia (1998-2003); Azerbaijan (1995-2001); Bangladesh (1991-2005); Cambodia (1993-2004); People's Republic of China (1993-2004); India (1993-2004); Indonesia (1993-2002); Kazakhstan (1996-2003); Republic of Korea (1993-2004); Lao PDR (1992-2002); Malaysia (1993-2004); Mongolia (1995-2002); Nepal (1995-2003); Pakistan (1992-2004); Philippines (1994-2003); Sri Lanka (1995-2002); Taipei, China (1993-2003); Tajikistan (1999-2003); Thailand (1992-2002); Turkmenistan (1998-2003); and Viet Nam (1993-2004); Income distribution for Republic of Korea and Taipei, China; expenditure distribution for the rest.

in expenditure levels, shown in Figure 4, are especially stark in terms of changes in levels of expenditure (the bars) as opposed to growth rates (numbers in parentheses). In fact, level increases in expenditures have been higher for the top 20% than bottom 20% even in those countries where Gini coefficients have declined, for example, Indonesia and Malaysia. More generally, the richest 20% have been the group experiencing the fastest increase in expenditures in a majority of the DMCs considered here.

The overall pattern that therefore emerges is one where a majority of developing Asian countries have seen increases in inequality (at least by the measures discussed above). By and large, however, increases in inequality are not a story of the “rich getting richer and the poor getting poorer”. Rather it is the rich getting richer faster than the poor.

Figure 4 **Changes in Per Capita Expenditures, 1990s-2000s, Bottom 20% and Top 20% (in 1993 PPP dollars)**

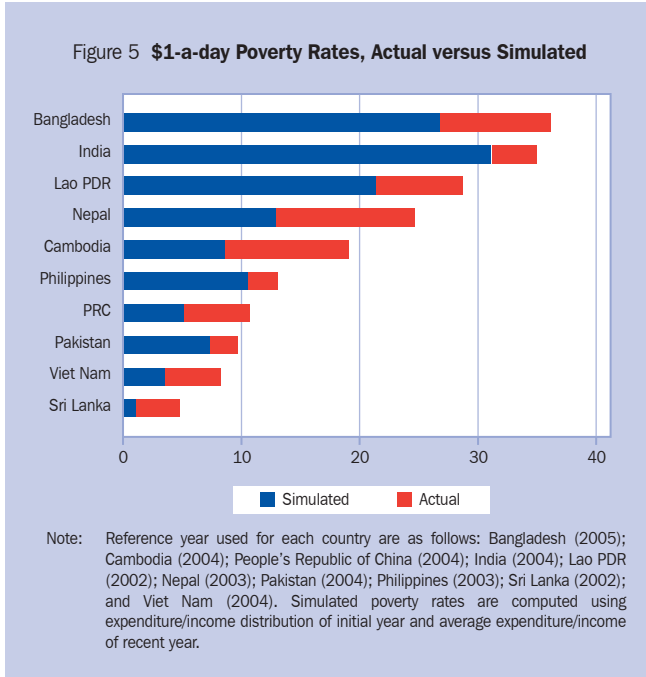


Note: Years over which changes are computed are as follows: Bangladesh (1991-2005); Cambodia (1993-2004); People's Republic of China (1993-2004); India (1993-2004); Indonesia (1993-2002); Lao PDR (1992-2002); Malaysia (1993-2004); Nepal (1995-2003); Pakistan (1992-2004); Philippines (1994-2003); Sri Lanka (1995-2002); Thailand (1992-2002); and Viet Nam (1993-2004). Numbers in parenthesis pertain to annualized growth rates.

3. Why Does Inequality Matter?

Increasing Inequality and its Impact on Poverty Reduction

Increases in inequality damp the poverty reducing impact of a *given* amount of growth. An illustration of this point can be useful. Figure 5 shows, for the 10 DMCs in which the Gini coefficient increased and in which \$1-a-day poverty rates were not negligible to begin with, both the actual changes in \$1-a-day poverty rates that took place; and the changes in poverty rates that would have taken place with the same growth (in mean per capita expenditures) as actually took place, had inequality remained at its previously lower level.



As the figure shows, poverty rates would have been lower—sometimes considerably so—had the economies in question been able to achieve the growth in mean per capita expenditure that they did *but* with their previous and more equal distributions.

A High Level of Inequality May Hinder Growth Prospects

A dominant view in post-World War II development circles was that high inequality facilitated the growth process. Additionally, growth itself could be expected to lead to greater inequality. The following quote by Nobel laureate Arthur Lewis captures well the thinking of the time:

“Development must be inegalitarian because it does not start in every part of an economy at the same time. Somebody develops a mine, and employs a thousand people. Or farmers in one province start planting cocoa, which grows in only 10% of the country. Or the Green Revolution arrives

to benefit those farmers who have plenty of rain or access to irrigation, while offering nothing to the other 50% in the drier regions” (Lewis 1983).

While there is considerable force behind Lewis’ quote, the development experience of Asia’s newly industrializing economies—especially Korea and Taipei, China—among others, has revealed that a rapid rise in inequality is not an inevitable result of high economic growth.

Moreover, there are reasons to believe that high levels of inequality may adversely impact future growth and development prospects. Many of the specific mechanisms highlighted by recent literature either work through “wealth effects” or political economy arguments. For example, those with little wealth or low incomes typically find it hard to invest in wealth- or income-enhancing activities. In principle, they may be able to borrow to finance investment. But imperfect financial markets coupled with other market failures—all of which can be safely assumed to be widespread in developing countries—can seriously constrain the ability of otherwise creditworthy individuals to borrow in order to finance investments in education or business opportunities, or even to insure themselves from the risks associated with potentially profitable ventures.

As for political economy considerations, high levels of inequality may lead to pressures to redistribute. Redistribution, in turn, may lower growth because it is executed through distortionary mechanisms. Alternatively, the process of bargaining that accompanies the call for redistribution, ranging from peaceful but prolonged street demonstrations all the way to violent civil war, may be extremely costly. High levels of inequality may also diminish growth prospects if concentration of incomes enables the wealthy to tilt economic outcomes and policies in their favor.

Some recent evidence of how inequalities (and poverty) can lead to conflict and thereby undermine growth comes from Nepal

where a “people’s war” was started by Maoist insurgents in 1996. At least two separate studies that have analyzed the determinants of the intensity of conflict across Nepal’s districts have uncovered a possible role for social and economic inequalities in explaining why some districts have been more adversely affected by conflict than others. One study, for example, found that a lack of economic opportunities (measured in terms of higher poverty rates or lower literacy rates) is significantly associated with a higher intensity of violent conflict (Do and Iyer 2006). In particular, the study suggests that a 10 percentage point increase in poverty is associated with 23–25 additional conflict-related deaths.

4. What is Driving Increases in Inequality?

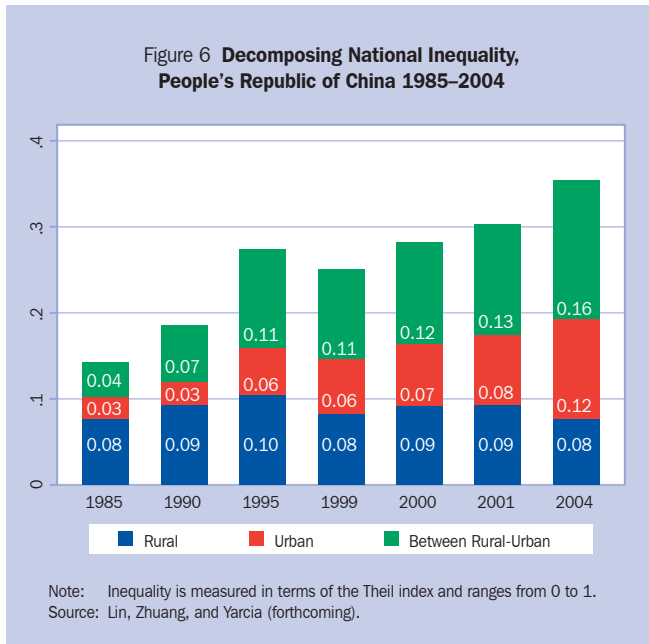
Proximate Drivers: Unevenness in Growth

A useful way to think about the increases in inequality we have seen taking place in many DMCs is in terms of the different ways in which growth has been uneven.² Three dimensions of uneven growth seem especially pertinent for accounting for increases in inequality in many parts of developing Asia. First, growth has been uneven across subnational locations (i.e., across provinces, regions, or states). Second, growth has been uneven across sectors – across the rural and urban sectors, as well as across sectors of production (especially, agriculture versus industry and services). Third, growth has been uneven across households, such that incomes at the top of the distribution have grown faster than those in the middle and/or bottom.

In the case of the People’s Republic of China, unevenness in growth across provinces has been found to be an important contributor to increases in inequality in the early to mid-1990s. However, perhaps the largest contributor to increases in inequality from the mid-1980s

² This way to proceed follows the recent work of Chaudhuri and Ravallion (2006).

to the 2004, have been differentials in incomes across rural and urban households. At the same time, uneven growth in incomes among urban households has also become a prominent source of the more recent increases in inequality. These patterns can be seen in Figure 6, which decomposes national inequality into inequality within each of the rural and urban sectors and inequality between the rural and urban sectors.

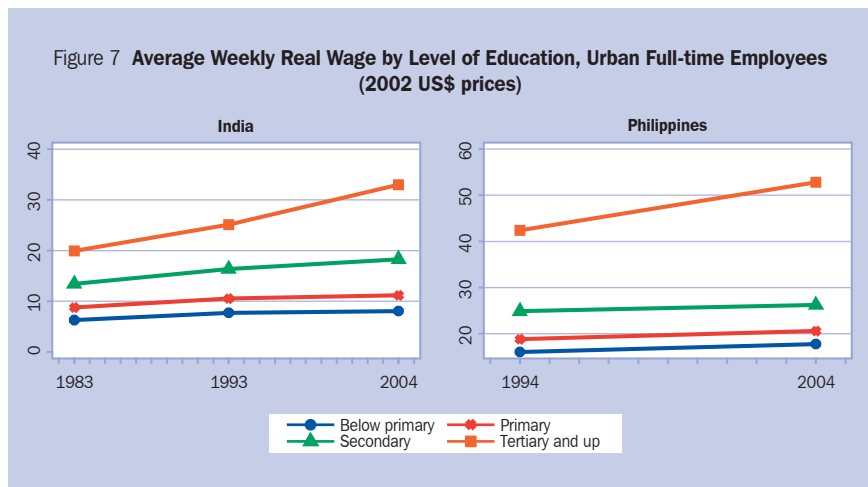


These observations also apply—though to varying degrees, of course—to other countries where inequalities have increased. In the case of Viet Nam, analysis of microdata on per capita household expenditures reveals that growing differentials in rural-urban and regional expenditures account for 108.4% of the increase in the Gini coefficient between 1993 and 2002; in other words, had other factors not worked to damp increases in inequality, the Gini coefficient would have registered an even larger increase than it did.

Similarly, in Nepal very unequal growth across urban and rural areas has been an important factor underlying the substantial

increases in inequality (recall Figure 3). While real per capita expenditures increased by 42% in urban areas between 1995 and 2003, rural areas saw only 27% growth (World Bank/ DFID/ ADB 2006). Given that rural areas started out with lower expenditures/ incomes, the lower growth rates only served to widen dramatically the gaps between rural and urban areas. Similarly, while real average per capita expenditures rose by about 30% in Kathmandu and the rural Western Hills and Eastern Terai regions, they increased only by about 5% in the rural Eastern Hills region.

Crucially, uneven growth in incomes and expenditures among households residing in urban locations has been a key source of widening inequality in many countries. In particular, widening differentials in earnings of the college-educated vis-à-vis less-educated individuals appears to be the single most important observable factor accounting for increasing inequality. Figure 7, which shows how average wages have evolved for full-time urban employees with different educational attainments in India and the Philippines, reflects this.³



³ Decompositions of changes in wage inequality among urban Indian full-time employees reveal that a little more than 80% of the change in the Gini coefficient from 40.5 in 1993 to 47.2 in 2004 can be accounted for by differences in educational attainments among workers.

Policy Drivers

What policy factors account for these patterns—in which growth in urban areas, in certain (leading) regions, and incomes accruing to those with high levels of education—have outstripped their counterparts' (i.e., rural areas, lagging regions, and incomes of those with less than a college degree)? The complexity of the issues prevents definitive conclusions. However, some important themes emerge.

First, the relatively slow growth of agriculture—certainly relative to the growth of industry and services, but also relative to agricultural growth before the 1990s—is one explanation for uneven growth across sectors (rural/urban, agriculture/nonagriculture). Because the bulk of the poor in much of developing Asia rely on agriculture for their livelihoods, its slow growth can also account for relatively slow growth in their incomes.

What can explain slow growth of agriculture? The specific reasons for this vary by country. However, there appear to be some common features, including a slowdown of public investment in rural infrastructure and stagnation in resources devoted to developing and spreading new agricultural technologies in the face of rapid depletion of natural resources. In some countries, a policy environment that has kept private investment away from agriculture seems to have exacerbated the lack of public investment.

Second, the interplay between market-oriented reforms, globalization (or international integration), and technology likely plays a major role in unequal growth. For example, in the case of the People's Republic of China there is a general consensus among analysts that sharpening income disparities between coastal and interior regions have been driven by the country's increased openness. Similarly in the case of India, the process of industrial deregulation (an important component of market-oriented reforms in the country from the mid-1980s to the early 1990s) has been associated with a greater concentration of overall investment in

certain locations. More generally, the interplay between market-oriented reforms and economies of agglomeration appears to have given certain regions within countries an edge when it comes to economic growth. Indeed, this interplay has been recently linked to increasing inequality in Southeast Asia and East Asia's middle-income countries as well (Gill and Kharas 2007).

As for the links between market-oriented reforms, globalization, and technology on the one hand and unevenness in growth across households on the other, several channels appear to be operating. The fact that the earnings of the best educated have increased most rapidly in so many countries—a phenomenon that can go a long way in explaining a considerable part of the increase in inequality—is consistent with the popular argument that closer international integration has introduced “skill biased” technologies to the developing world. However, more could be at play. In an era where capital has become increasingly mobile, but where labor—especially the less skilled—continues to be far less mobile (certainly across countries, but within countries as well), the bargaining power of labor may well have taken a hit and led to slower growth of labor incomes (again, especially among the less skilled).

More generally, it is the more educated who will typically be in the best position to make the most of the opportunities that market reforms and international integration bring. This may be because education itself confers special advantages to individuals (e.g., engineering degree holders who could capitalize on the boom in information technology by virtue of their computer programming experience). Alternatively, the individuals who are most able to seize the opportunities are the ones most likely to have a college education in the first place (e.g., English-speaking young adults who could capitalize on the boom in information technology-enabled services).

5. Public Policy and Inequality

What should be the response of public policy to inequality? The evidence in the special chapter reveals that increasing inequality in developing Asia reflects not so much “the rich getting richer and the poor getting poorer”, but the rich getting richer *faster* than the poor. It is quite likely that fast growth of incomes among the rich has been driven, to a considerable degree, by the opportunities unleashed by market-oriented reforms, international integration, and new technologies. One way to deal with growing inequality would be to significantly roll back reforms and engagement with the international economy. However, this is unlikely to be feasible or even desirable. Lewis’ (1983) view that development is inherently inegalitarian may not be strictly correct in the aggregate, but there appears to be considerable force behind his point that the process of development is unlikely to start in every part of an economy at the same time. The gains from market-oriented reforms and international integration may be seen in a similar way.

At the same time, the historical record of today’s developed countries does not show declining inequalities to be an automatic outcome of continued economic development. Given that high levels of inequality and/or rapidly increasing inequality can imply slow improvements in the economic well-being of the poor even in a growing economy, and can also undermine both social cohesion and the quality of policies and institutions, public policy cannot simply ignore inequality.

A pragmatic way forward would be to focus on policies that would significantly lift the incomes of the poor—defined broadly here to include not only those living in extreme poverty but also those such as the \$2-a-day poor—by enabling them to access the opportunities that reforms and integration bring, while recognizing and limiting the very real danger that concentrations of income and wealth pose for social cohesion and growth-promoting policies and institutions.

The precise design of public policy will depend on and vary by country context. However, it is possible to outline some general principles for policy.

Effort versus Circumstances: Equalizing Opportunities

Echoing recent work, it is useful to try and distinguish between two types of inequality: that driven by circumstances beyond the control of individuals; and that driven by effort and reflecting the rewards and incentives that a market economy provides to its citizens for working harder, looking out for new opportunities, and taking the risks entailed in seizing them. From this perspective, it is circumstance-based inequalities that give rise to *inequality of opportunities* and must be the target of public policies aimed at reducing inequalities. Admittedly, making a clean distinction between effort and circumstances is not straightforward. In the real world, there are bound to exist a plethora of circumstances that lead to inequalities in opportunity. There can also be differences of opinion on what constitutes circumstances and what constitutes effort.⁴ But even with these difficulties, it is relatively easy to identify the most extreme circumstances that severely limit opportunities for many people. These circumstances relate, especially among the poor, to social exclusion, lack of access to high-quality basic education and health care, and lack of access to income- and productivity-enhancing employment opportunities. Such circumstances are not only fundamentally unfair, they are also likely to work as serious

⁴ While race, caste, and gender certainly qualify as circumstances individuals find themselves in, and clear and worthy targets of policy to attack when opportunities are limited on account of these, things become murkier as we broaden the list of opportunity-affecting circumstances that individuals may find themselves in. How about being born to parents who don't instill good work ethics in a child? Is the child then responsible for the low effort that he or she expends as a working adult? At a different level, are the vastly high sums being paid to CEOs in many countries truly commensurate with their effort? Yet another layer of complexity enters when effort is a function of circumstances. For example, faced with discrimination in the labor market, an individual may well decide to forgo expending effort.

constraints to poverty reduction, social cohesion, and economic growth; such circumstances must form a primary target of policy.

Expanding employment opportunities for the poor involves policies that expand opportunities for the poor and nonpoor

Policies that improve productivity and incomes in the rural sector and urban informal economy are vital for generating better employment opportunities for the poor (ADB 2005). Such policies also need to be combined with policies that generate employment opportunities more generally in the economy, including those for the nonpoor. For example, industrial policies that promote structural change are crucial for economic development (ADB 2007). It may well be the case that the first beneficiaries of structural change are the nonpoor. Similarly, a policy that improves access to finance may well, in the first round, benefit lower-middle-income groups running small and medium enterprises. Or trade policy might benefit the more educated. The key challenge in these situations is to determine and implement complementary policies that can counter the negative (if any) distributional impacts of such policies, and facilitate the ability of the poor to access the opportunities that these policies provide.⁵ Ultimately, it is the overall policy framework, and how the various policies interact and complement one another that matter (World Bank 2005).

Some redistribution is inevitable in promoting greater equality of opportunity

Redistribution can occur at many levels. At one level, it can involve the redistribution of assets, such as land or access to it. At

⁵ In the case of liberalizing trade policies, for example, strengthening of social protection mechanisms and providing appropriate skills and training programs could be useful to mitigate some of the adverse distributional impacts that may accompany an increase in import competition. Similarly, where the export response of trade liberalization is muted (for example, the failure of labor-intensive exports to take off), a careful assessment of policy or structural impediments to such a take-off needs to be made and action taken accordingly.

another level, it can involve realignment of the recipients of public expenditures and public investments. For example, some amount of switching of public expenditures from tertiary education to basic education, and from urban to rural areas from current norms may be critical for improving the access of the poor to basic social and physical infrastructure.

Getting the design of redistributive policies right is critical

Correct design is crucial for securing the intended effects. Equally, it is vital that redistributive policies do not hurt a perhaps still nascent growth process. This may happen if redistribution damps the incentives for investment (for example, through an overly steep tax on incomes or assets). It can also happen in other ways. For example, self-interested lobbies may introduce and capture redistributive policies in the name of fairness.

The challenge of designing redistributive policies that are well targeted, effective, and funded through mechanisms that do not detract from economic growth is, certainly, formidable. But the need for redistributive policies will not go away – especially if increasing inequalities turn out to be an enduring feature of developing Asia over the next two or three decades. It is imperative for all concerned stakeholders, including policy makers, to learn the from mistakes and successes of past attempts at redistribution.

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