Rising Inequality: A global challenge

Lim Mah Hui

Significance

It is widely believed the growth based on free markets is what matters, and that the benefits of growth will automatically trickle down to the rest of society. This neo-liberal theory of growth is now challenged by overwhelming evidence that despite rapid growth, economic inequality has been rising in most countries particularly in Asia. The 2012 Asian Development Bank Report showed that 13 of 36 Asian economies had Gini index of 40 and above, and 11 economies covering 82% of Asia's population experienced worsening inequality.

Why should we worry about rising inequality?

Rising inequality threatens not only social and political stability but also economic growth and financial stability.

Economists often use Gini index to measure the degree of economic inequality in a country. Ranging from a scale of 1 to 0; 1 refers to absolute inequality and 0 to absolute equality. Countries with Gini index of over 0.4 are regarded as highly unequal. In Asia, these include Singapore (0.47), China (0.51), Malaysia (0.46), Philippines (0.43), India (0.40), Pakistan (0.68 estimated by some sources) and many others. In many cases this index is rising. In the rich countries, US with Gini of 0.46 stands among the most unequal.

A more revealing, but less used, measure of economic inequality is functional income distribution, i.e., the percentage of a country's GDP going to labour (wages and benefits) compared to capital (profits, rents, interest). Figures 1 shows that the labour share of GDP in four of five selected Asian countries has declined over the last few decades. In China, it dropped from 60% to 48%, in Malaysia from 42% to 30%. Even in Korea that has a relatively low Gini index, labour share of GDP ranged from 48% to 43%.

Why is this happening?

Technological change is often cited as the major driver of income inequality, (technology favours workers with higher level of education and skills and hence the income gap between skilled and less skilled labour widens). However, beyond this, there are other important factors to consider. Chief among these are events related to forces of globalization, financialization, and international relocation of production – all of which weakened the bargaining power of labour in the less developed as well as the developed countries. With the collapse of the Bretton Woods Agreement in 1971, the international monetary system went off the US dollars-gold standard, and from fixed to floating exchange rate. Financial liberalisation ushered in the era of free international capital flows. Together with changes in technology and business organization, multinational corporations can now freely invest and relocate production anywhere in the world, pitting one country against another. The entrants of billions of unemployed or underemployed workers in peripheral countries like China, India and Southeast Asia into the global workforce facilitated the **global arbitrage of labour**, i.e., capital is now able to move freely in search of countries with the lowest costs. Many Asian countries competed, and still do, for foreign investments by repressing unions and wages which puts a brake on wage rise in both poor and richer countries. This weakened labour's bargaining power globally and is reflected in the rise of temporary and contract labour and stagnating or declining labour share of GDP. As a result of these forces, wage growth did not keep up with the rise in labour productivity in many countries. This is illustrated in Figures 2, 3 and 4 for China, Malaysia and Korea respectively.

Consequences & Impact of Rising Inequality

The implications and consequences of rising economic inequality are multi-faceted. First, social and political democracy is undermined when there is extreme inequality. The ADB did a survey of over 500 national policymakers in Asia in 2012 and found that 95% of respondents think it's important to have policies to prevent further rise in inequality to maintain political stability and economic growth. Alan Greenspan, the former Governor of the Federal Reserve Bank, put it succintly when he said in 2007 that whilst he does not understand why there is this long-term divergence between productivity and wage growth, he is worried that if the trend continues unabated, political democracy will be threatened. The Occupy Wall Street movements in the US and other parts of the world that followed in the wake of the global financial and economic crisis speak to this risk.

Second, beyond, political and social instability, rising inequality is also not good for financial stability and economic growth. A recent IMF study shows that inequality is not good for long-term growth. While it is possible to produce growth spells, irrespective of inequality, the study finds that income distribution is one of the most robust predictor of sustained growth. Furthermore extreme inequality misallocates human resource development and is often associated with weak institutions and governance. It also concludes that redistribution of income does not negatively affect growth.

Thirdly, inequality is related to financial instability. The recent global financial crisis is not simply the result of greedy bankers, poor corporate governance, and banking regulations, although these problems must be addressed. There are even more serious underlying structural causes to the crisis, one of which is rising inequality. It is widely recognized that global trade imbalance contributed to the recent global financial crisis, i.e., China and other Asian countries have enormous trade surpluses which funded the huge trade deficit in US. But behind this trade imbalance is wealth and income imbalance. China's declining GDP wage share is reflected in its drastic drop in personal consumption (from over 50% to 35% of GDP in the last four decades) and the concomitant rise in its savings rate from about 30% to 50% of GDP. This excess of savings over investment, which is the current account surplus, is recycled through the international financial system and funded US debt-driven consumption which reached 72% of GDP in 2007. How was it possible for consumption to rise when real wages were either stagnating or even declining in the US? Essentially consumption was supported by debt rather than income. Between 1960 and 2006, US GDP rose 26 times but household debt 64 times reaching close to 100% of GDP in 2006. Much of this was mortgage debt that eventually imploded in 2007. Wages are not simply a cost factor in economic growth; it is also an important factor driving aggregate demand. If wages are repressed, then aggregate demand and economic growth are negatively affected unless there are compensating mechanisms to prop up aggregate demand. Debt is one such mechanism. However, there are risks and limits to pumping up consumption through debt as amply demonstrated in the US financial crisis.

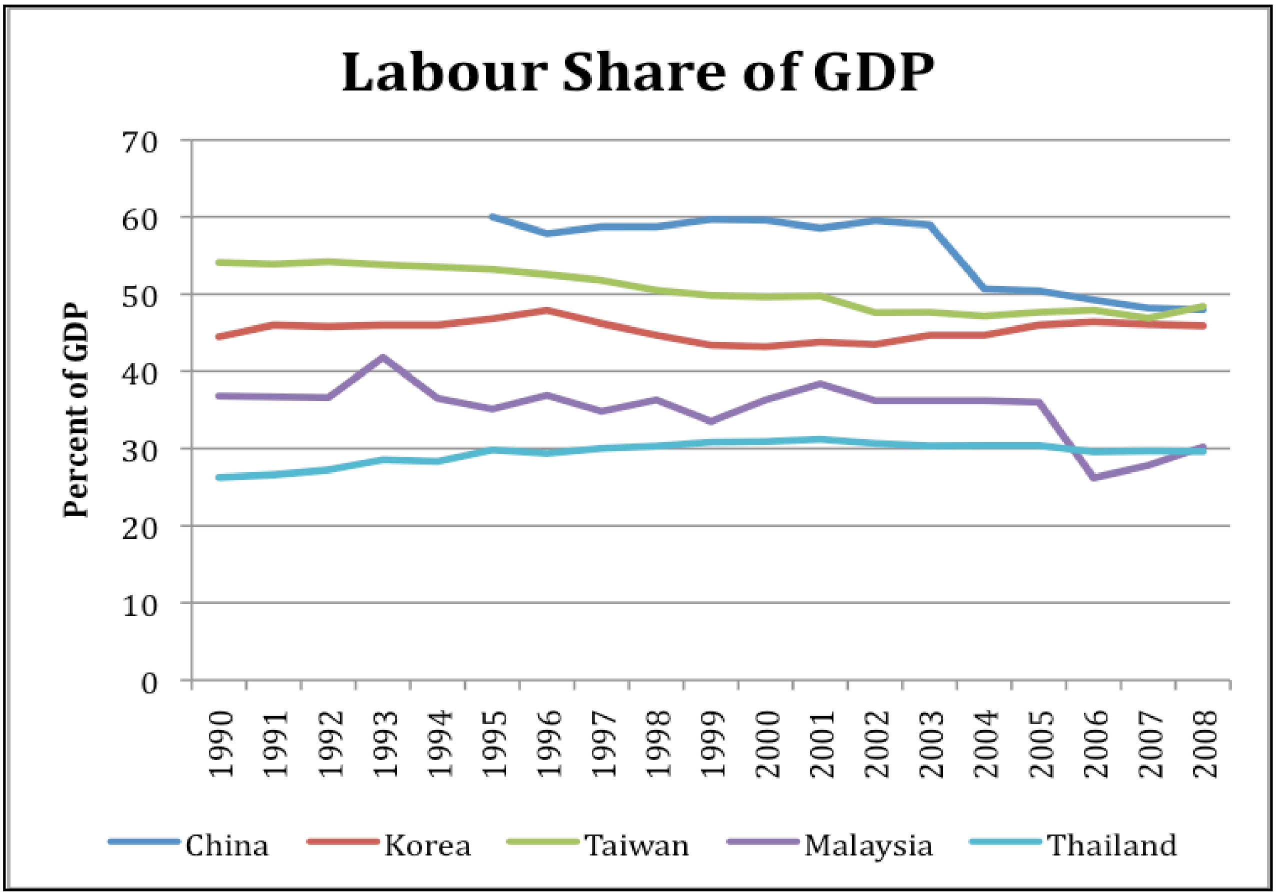
A number of Asian countries are exhibiting similar tendencies. In Korea and Malaysia, where wage share is declining due to wages falling behind productivity growth, household consumption and debt have been climbing to dangerously levels. Household debt to GDP reached 89% in Korea in 2010, and 87% in Malaysia in 2013. Even more alarming, houshold debt to disposable income is 164% in Korea (2012) and 140% in Malaysia (2010). The lesson from the US debt driven consumption and financial crisis because of rising inequality and declining wage share should serving as a warning to these countries.

What Next?

Given the significant risks of unchecked rising inequality, what should or can be done? It is possible to address this issue from an ex-ante and/or ex-post manner in terms of income distribution. Tackling it in an ex-ante manner, it is clear that real wages must rise in tandem with increases in productivity to support healthy aggregate demand growth. A prolonged divergence of the two trends, with either wages lagging behind productivity increases or over-shooting productivity increases, is economically and politically destabilizing. Addressing it in an ex-post manner, state policies can reduce inequality through more progressive fiscal policies – progressive taxation, higher capital gains tax, and provision of better social services and safety nets. In the past three decades, government policies in many have favoured the wealthy with reduction in income and capital gains taxes, cut back in social spending and safety nets. Essentially state policies have exacerbated inequality.

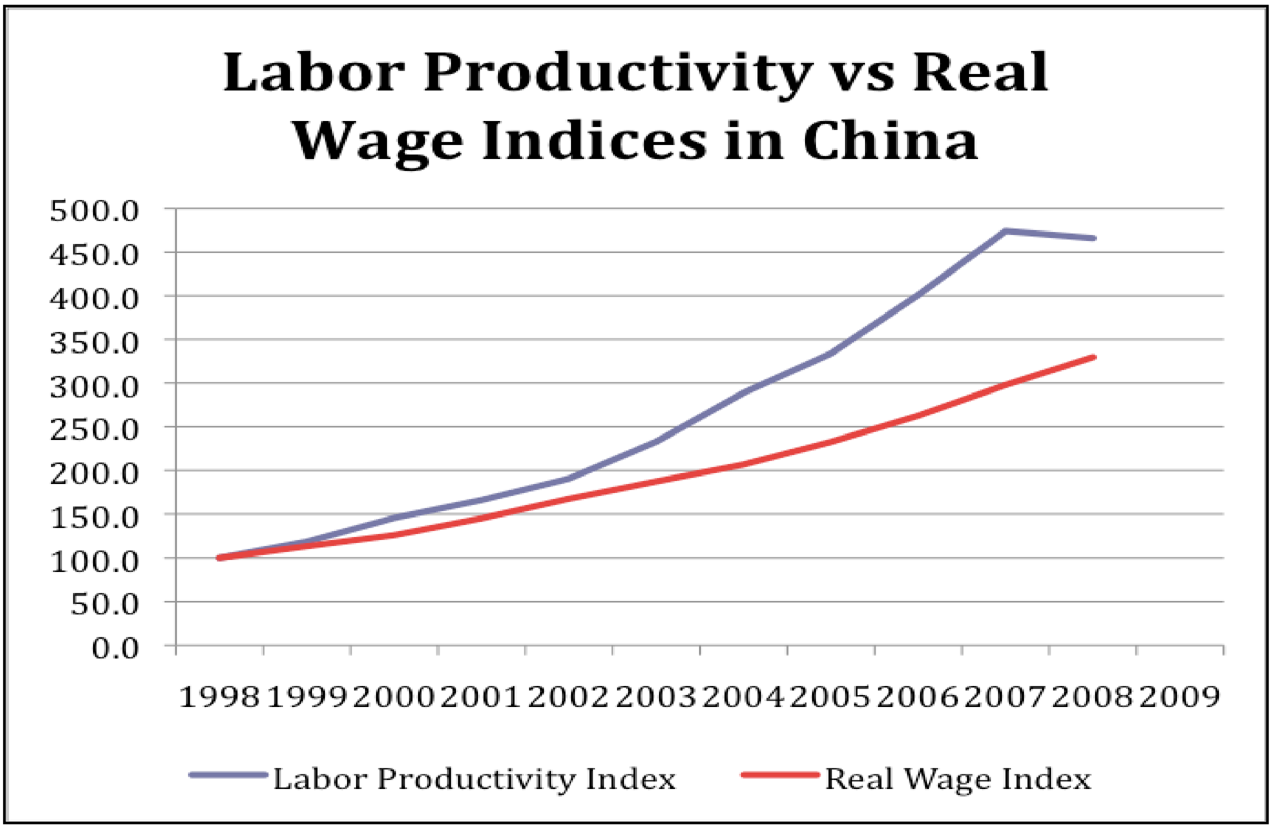
The pendulum of inequality has veered too far over the past few decades and something must be done to bring it to balance.

Figure 1: Labour Share of GDP in 5 Selected Asian Economies, 1990-2008



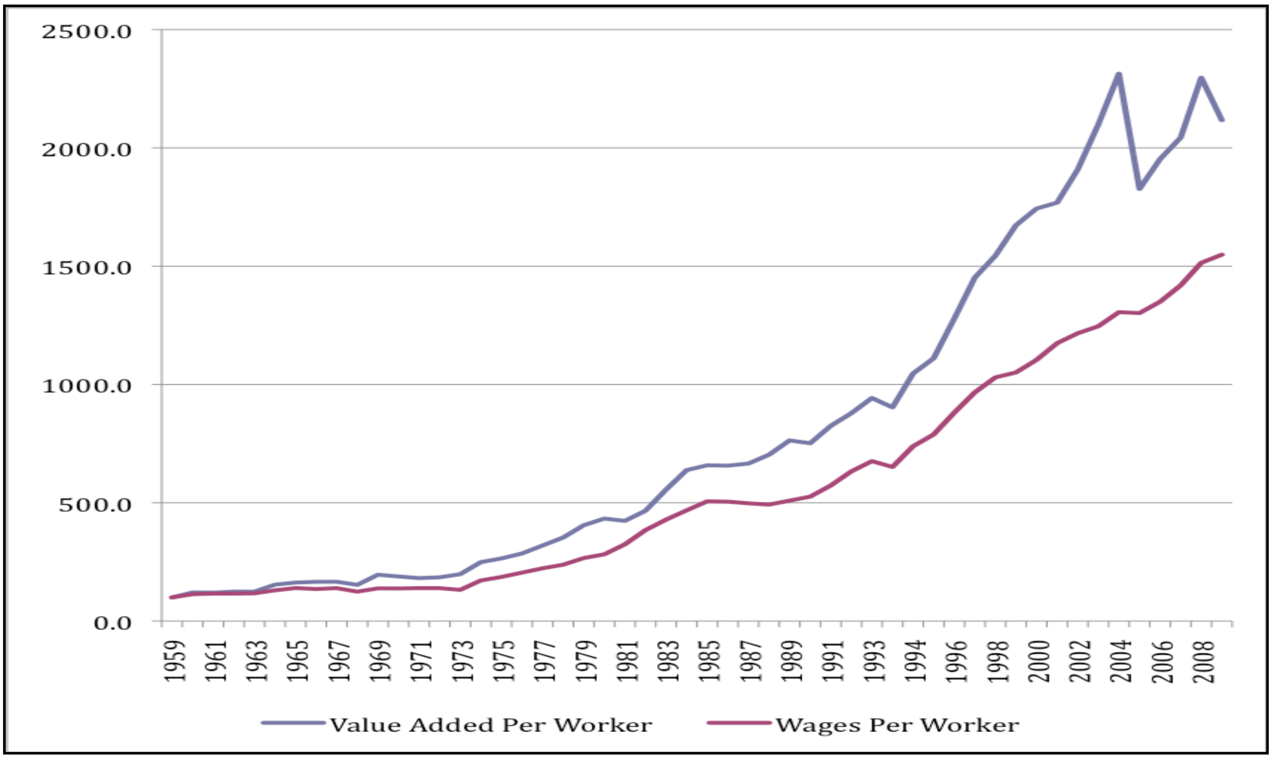
Country:	Source
China	ILO
Korea	Bank of Korea
Taiwan	Statistics from Directorate General of Budget, Accounting and Statistics, Executive Yuan, R.O.C.
Malaysia	Shymala and Goh n.d.; Dept of Statistics Malaysia
Thailand	Source: National Income of Thailand, National Economic and Social Development Board

Figure 2: Productivity and Wages Indices,China



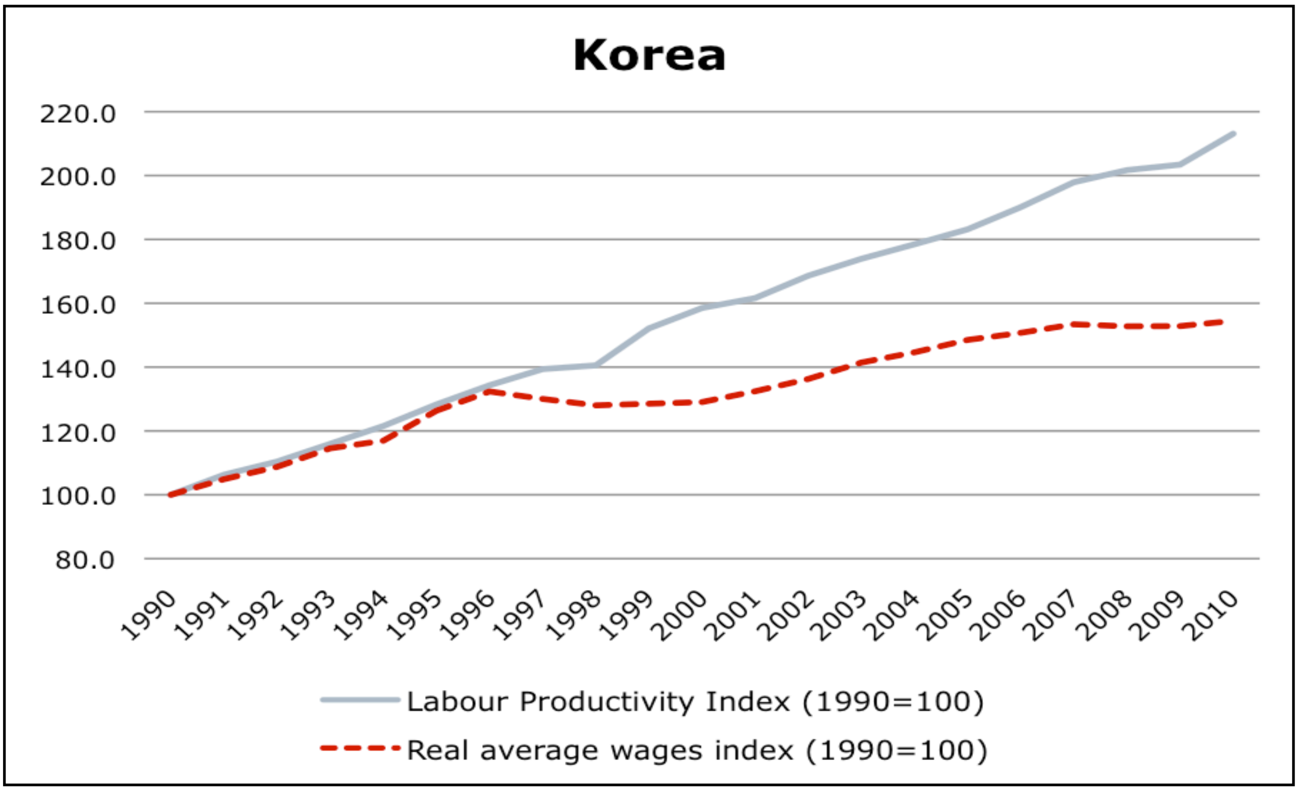
Source; CEIC database

Figure 3: Labour and Wage Indices in Malaysia's Manufacturing Industry



Source: Department of Statistics, Malaysia

Figure 4: Labour and Wage Indices in Korea



Source: OECD reports