

China's Reform and Opening-up

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Part II. Challenges for China's Economic Reform and Opening-up: Special Issues

- **Local Debts, Land Finance, and Central-Local Relationship**
- **Urbanization, Industrialization, and Investment Driving Force**
- **Private Enterprises, Financial Constraints, and Marketization**
- **Regional Partition, Urban-rural Partition, and Inequality in China**

Part II. Challenges for China's Economic Reform and Opening-up: Special Issues

Lecture 6. Challenge 4-Regional Partition, Urban-rural Partition, and Inequality in China

Inequality

- ❖ What are the main factors of China's inter-regional and urban-rural disparity? Is there any possibility to equalization? Are policies like west-exploring or education equalization successful? How will inequality influence China's future growth?

Knight (2013)

China's poverty and inequality decreased dramatically in 1978–1985 during the years of rural reform, when farming was decollectivized, household production was restored, and farm incomes responded. It is possible to obtain a fairly consistent

It was inevitable that income inequality would increase significantly as China moved from a centrally planned economy, in which egalitarianism was a cornerstone, to a market-based economy. Material incentives were needed to induce greater effort, saving, investment in physical and human capital, and entrepreneurship. Similarly, economic efficiency was likely to be enhanced by disequalizing processes of cumulative causation. Nevertheless, some of the increase in income inequality was difficult to justify in terms of either efficiency or equity. Much of this unjustified inequality stemmed from the **institutional framework** within which China's semimarketized economy operated.

Table 1. The Gini Coefficient of Income Inequality for Selected Large Developing Countries, Circa 1988 and Circa 2007

	Knight(2013)		
	Circa 1988	Circa 2007	Change
China (World Bank)	0.30	0.43	0.13
(CHIP surveys)	0.38	0.49	0.11
Bangladesh	0.29	0.32	0.03
Brazil	0.61	0.56	-0.05
Egypt	0.32	0.31	-0.01
India	0.32	0.33	0.01
Indonesia	0.29	0.34	0.05
Iran	0.44	0.38	-0.06
Nigeria	0.39	0.49	0.10
Pakistan	0.33	0.30	-0.03
Philippines	0.41	0.43	0.02
Russian Federation	0.24	0.43	0.19
South Africa	0.59	0.63	0.04
Thailand	0.44	0.41	-0.03
Turkey	0.44	0.39	-0.05
Vietnam	0.36	0.36	0.00

Notes: All earlier figures fall within the 1986–1990 period except Vietnam (1993) and South Africa (1993), and all later figures fall within the 2005–2010 period. The (alternative) CHIP estimates for China will be explained below.

Source: worldbank.org/indicator/SL.POV.GINI; Griffin and Zhao (1993); Li et al. (2013).

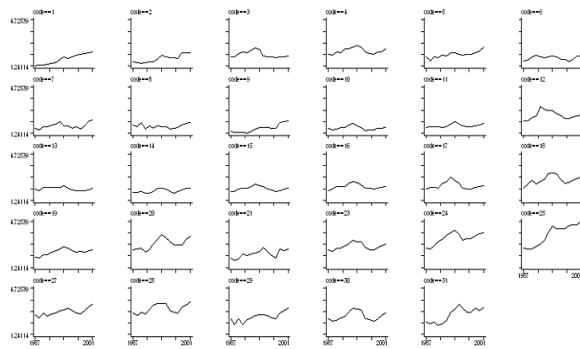
Gini coefficient in China

Year	rural	urban	national	
❖1988	0.34	0.23	0.38	
❖1995	0.43	0.29	0.45	CHIP Survey
❖2007	0.36	0.34	0.49	Li et al.(2013)
❖Now: >0.473				
	☞NBS: 0.473			
	☞LI Shi: 0.51			
	☞GAN Li: 0.6			

Inequality Components

- ❖(1) Urban-rural
- ❖(2) Interregional
- ❖(3) Intra-rural
- ❖(4) Intra-urban

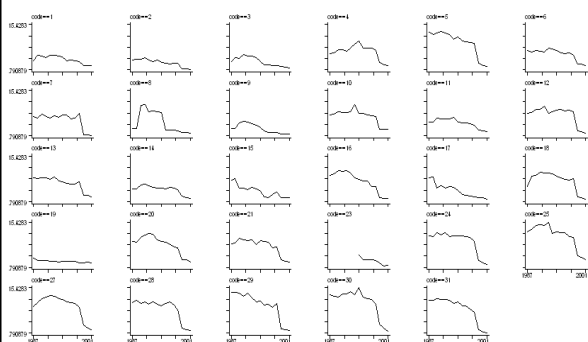
6.1 Urban-Rural Inequality



Main Causes of Urban-Rural Inequality

- ❖ Lu and Chen (2004)
 - 🌀 Urban-biased policies.
 - 🌀 Economic opening.

Urban Biased Policies: Fiscal expenditures supporting agriculture



Urban-Biased Policies (Yang, 1999)

- ❖ Yang, Dennis Tao, 1999. "Urban-biased policies and rising income inequality in China", American Economic Review, 89 (2), 306–310.
 - 🌀 Rural-urban income differentials have been the quintessential driving factor behind inequality
 - 🌀 Urban-biased policies and institutions including labor mobility restrictions, welfare systems and financial policies of inflation subsidies and investment credits to urban sector

Background Information

- ❖ China has experienced the biggest increase in inequality of any country since the 1980s
- ❖ Yang seeks to explain this through institutional reforms instituted in 1978 causing:
 - ↪ Work incentives replacing egalitarian rewards
 - ↪ Employment contracts
 - ↪ Labor mobility
- ❖ Methodology: household survey data by China's State Statistical Bureau (SSB)
 - ↪ Analyzing Gini ratios and generalized entropy measures

Three Components of Inequality

1. Rural areas
2. Urban areas
3. Sectoral disparity

Survey Data

- ❖ Sample population increase over time uses household survey data of 1986, 1992, and 1994
 - ↪ Sichuan: 4826 to 6601
 - ↪ Jiangsu: 2931 to 4233
- ❖ Differ in terms of income level, geography (Sichuan is central China and Jiangsu is coastal)
 - ↪ Sichuan figures are below, Jiangsu figures are around the national average

Shortcomings

- ❖ Incompatible definition of income between urban and rural questionnaires
- ❖ No adjustment for cost of living / PPP
- ❖ Excludes housing subsidies and medical services in urban income
- ❖ Downward bias evaluation of grain output

TABLE 1—OVERALL GINI RATIO AND ITS DECOMPOSITION

Year	(i) Overall	(ii) Urban	(iii) Rural	Between-sectors	
				(iv) G^B	(v) O^B
<i>Sichuan:</i>					
1986	0.278	0.005	0.149	0.117	0.007
1988	0.320	0.013	0.133	0.167	0.007
1992	0.359	0.014	0.129	0.213	0.003
1994	0.392	0.018	0.128	0.242	0.004
<i>Jiangsu:</i>					
1986	0.276	0.007	0.164	0.088	0.017
1988	0.302	0.015	0.170	0.089	0.028
1992	0.327	0.013	0.163	0.129	0.022
1994	0.349	0.015	0.169	0.144	0.021

Notes: Column (i) gives the overall Gini ratio, G ; column (ii) shows the urban component, $\nu_U^U G^U$; column (iii) shows the rural component, $\nu_R^R G^R$; columns (iv) and (v) present the between-sectors components, G^B and O^B .

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Persistent Income Growth Over 8 Years

- ❖ Real per capital income increased from
 - ☞ Sichuan
 - 843 to 1422 yuan in urban
 - 370 to 450 yuan in rural
 - ☞ Jiangsu
 - 1069 to 1705 yuan in urban
 - 619 to 872 yuan in rural
- ❖ In both provinces, urban-rural gap doubled
- ❖ Broadly consistent with national level data

1
8

Summary Statistics:

Table 1

$$(i) = (ii) + (iii) + (iv) + (v)$$

- ☞ (i) Upward Trend in per Capita Income Inequality in 2 Provinces
- ☞ (ii) inequality within urban
- ☞ (iii) inequality within rural
- ☞ (iv) difference in sectoral mean income
- ☞ (v) overlapping income
- * (ii) and (iii) are relatively constant overtime

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9

Summary Statistics

Table 1 (continued)

- ❖ Sichuan province: G^B terms are large, increase overtime O^B is small
- ❖ Jingsu province: G^B and O^B terms increased over time
- ❖ Sectoral income change (0.060) constitutes approximately 82% of increases in inequality (0.073) in Jiangsu
- ❖ 0.122 sectoral effects explain overall income inequality (0.114) in Sichuan

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Understanding of Income Inequality

Key Questions to Explore

- ❖ What are the institutions and policies that divide the rural and urban sectors?
- ❖ What are the causes of rising disparity in recent years?

2
1

The Root of the Rural-Urban Divide

- ❖ Centrally planned system that favored heavy-industry development
- ❖ Extracted agricultural surplus largely for urban capital accumulation
- ❖ Urban-based subsidies

2
2

The Main Enforcement Mechanisms

- ❖ The state control of agricultural production and procurement
- ❖ The suppression of food-staple prices
- ❖ Restrictions on rural-to-urban migration via a household registration system

2
3

Prior to the 1978 Reforms

- ❖ Capital goods were excessively concentrated in urban areas
- ❖ Large fraction of the labor force was restrained from leaving agriculture
- ❖ Result:
 - ✂ Urban workers' productivity and earnings far exceeded those of their rural counterparts

2
4

Policies to Reduce the Rural-Urban Division

- ❖ Increases in procurement prices for agricultural products
- ❖ Adoption of household responsibility systems
- ❖ The relaxation of restrictions on labor mobility to nonagricultural activities in rural areas and to employment in cities
- ❖ Result:
 - ↪ Rapid increases in farmers' earnings and consequently reduced sectoral disparity
 - ↪ Between 1978-1985:
 - Average rural-urban income ratio reduced from 2.9 to 2.2
 - Lowest in past four decades

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Disparities between Urban Residents & Rural Migrants

- ❖ State enterprises and other government agencies still manage and allocate a high percentage of city housing exclusively to their employees
- ❖ Only permanent workers receive health insurance/ services and pensions from the government work units
- ❖ Child care and education at elementary and middle school levels are available only to families of urban registration
- ❖ The government almost never grants urban registration to any migrant families

2
6

Disparities between Urban Residents & Rural Migrants

- ❖ Rural Families face substantially higher prices for goods and services provided by the PRC
 - ↪ Welfare
 - ↪ Health
 - ↪ Education
- ❖ Chinese farm households have the land-use rights, but not the rights of alienation
 - ↪ This means if rural families migrate, they have to return the land to local authorities and give up a stream of future land earnings

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Discrimination: The Financial Transfer Programs

- ❖ Between 1986 and 1992, China experienced an average inflation of 8.5%
- ❖ Increased government expenditures and investments that were partly responsible for causing the inflation were disproportionately allocated to the urban sector
- ❖ Shares of government budget devoted to:
 - ↪ Cities: 52% to 62%
 - ↪ Rural Economy: <10%

Although 73% to 76% of the population lives in rural areas

2
8

Discrimination: The Financial Transfer Programs

- ❖ During the same period (1986-1992), the government channeled higher levels and proportions of new loans to SOE's
- ❖ These transfer programs led to a scenario in which the wages of rural were primarily supported with output growth, while the wages of urban workers came in part from government fiscal transfers and creation of credits
 - ☞ As a result, consistently higher inflationary taxes were imposed on rural earnings, thus causing the rising rural-urban differentials

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Indirect Disparity: TVEs v.s SOEs

- ❖ After high inflation during the 1988-1989, the government launched a series of contractionary policies that tightened investment credits, particularly to rural industries
 - ☞ TVEs:
 - Real output dropped by 3.66% in 1989
 - Reduction of enterprises and the corresponding reductions in employment in 1989-1990
 - ☞ SOEs:
 - Total employment and real output of SOEs continued to expand during 1988-1992

These policy consequences either directly or indirectly lowered the earnings of the rural people

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Conclusion (Yang, 1999)

- ❖ Rural-urban income differentials have been the quintessential driving factor behind inequality
 - ☞ Gini Coefficient increased by over 50% from 1981 to 1995
 - ☞ Household surveys reveal income growth differentials consistent with national-level data
 - Rural-urban divide constitute a large share of national inequality

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Conclusion (Yang, 1999)

- ❖ Urban-biased policies and institutions causing income disparity:
 - ☞ Labor mobility restrictions
 - ☞ Welfare systems
 - ☞ Financial policies of inflation subsidies
 - ☞ Investment credits to urban sector, contracting credits for agriculture

These current urban-biased policies and institutions may harm China's future growth as workers' economic incentives are distorted by sector-biased income transfers and expenditures on health, housing, and education for generations to come.

6.2 Regional Inequality

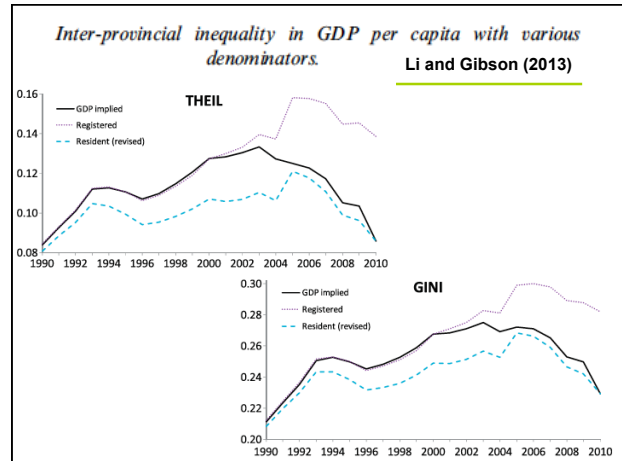
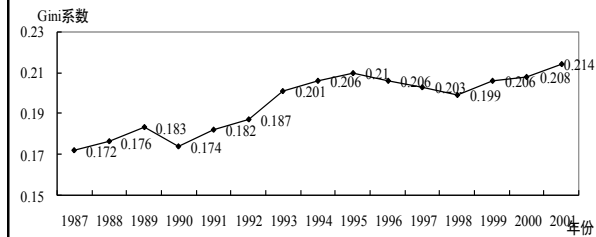
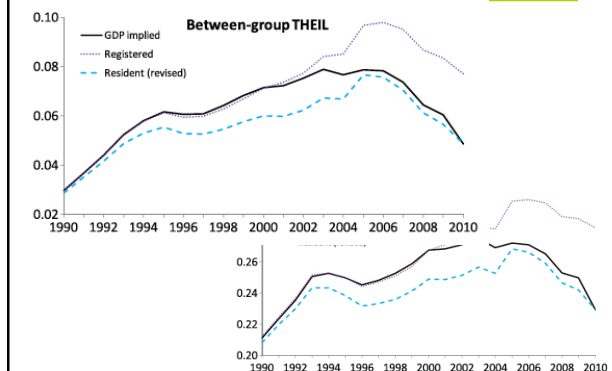


Figure 6. Coastal-inland inequality with various denominators for GDP per capita. Source: Decomposition of Theil index into within-group and between-group components. Li and Gibson (2013)



Main Causes of Regional Inequality

❖ Wan, Lu and Chen (2005)

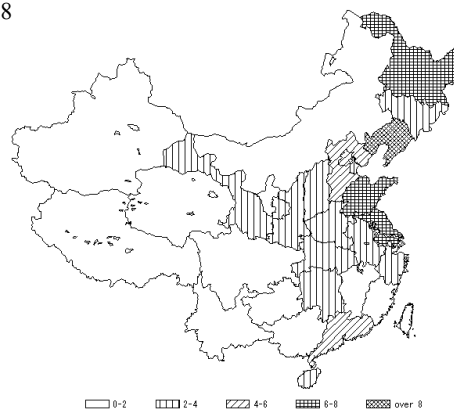
- ❧ Economic opening (FDI and trade)
- ❧ Capital
- ❧ Privatization
- ❧ Others: education, urbanization, geography, dependency ratio

Industrial Agglomeration

❖ Jin, Chen and Lu (2006)

- 🌀 Geography
- 🌀 Policy: opening

1978



2001



Poverty, Inequality and Growth

❖ Meng, Xin, Robert Gregory and Youjuan Wang, 2005, "Poverty, inequality, and growth in urban China, 1986–2000", *Journal of Comparative Economics*, 33(4), 710-729.

- 1990s Radical reforms:

- Increased income inequality
- Reduced social welfare provisions
- Increased grain prices
- Increased income uncertainty

Meng, Gregory and Wang(2005)

- ❖ The data from National Statistical Bureau Urban Household Income and Expenditure Survey (UHIES) from 1986 to 2001.
- ❖ The households are selected randomly countrywide and are expected to keep a diary of all expenditure.
- ❖ **The UHIES includes only households with Urban Household Registration (Hukou).** Rural migrant households are not included. Thus, this study actually understates total urban poverty

Meng, Gregory and Wang(2005): Findings

- ❖ Urban poverty rose until it reached a peak in 1993 and stabilized at a high rate until declining after 1997.
- ❖ This was mainly because of economic reforms raising grain prices and non-food necessities.

Meng, Gregory and Wang(2005): Findings

- ❖ There was high real income growth over the 15 year period
- ❖ However, the effect of saving, the relative price of food, the need to spend more on medical services, education, and housing, and growing income inequality contributed to an increase in poverty.
- ❖ Over the entire period, these four effects offset the positive effect of income growth on poverty reduction.

Meng, Gregory and Wang(2005): Findings

- ❖ There was wide disparity between poverty measured by income and expenditure
- ❖ This is mainly due to increased income uncertainty.
- ❖ Increased income uncertainty compels poor households to save more for the future.

Price Changes

❖ Example:

- ❧ Whole meal was consumed in the 1980' s, but later replaced by flour bread (previously considered to be a luxury good)
- ❧ Healthcare, education were preciously provided by the state, but has since adopted a pay-for-use practice, making families spend more on necessities aren't food.

Inequality by Definitions

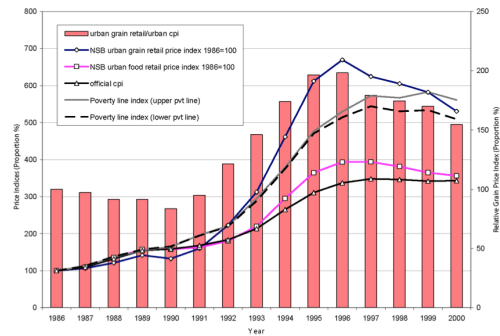
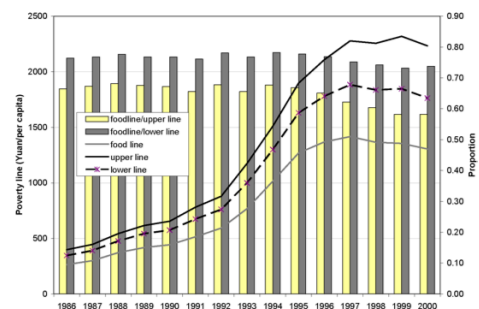


Figure 2, Meng, Gregory and Wang(2005)

Explanations

- ❖ Households can change their pattern of food consumption over time and based on region
- ❖ Poor households can substitute non-food necessities for food in line with reforms that strongly impact the pricing of non-food necessities like education and healthcare—this is essential for the study, especially during periods of rapid change

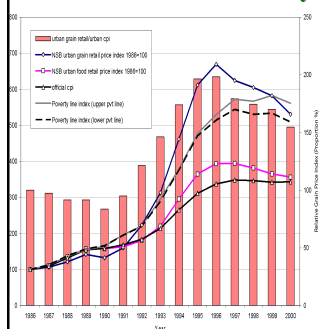
Poverty line by Definition



The food poverty line declines in the mid 1990's, indicating an increase in substitution of non-food necessities for food.

Figure 3, Meng, Gregory and Wang(2005)

Comparison of Price Indices and Poverty Indices



- Official CPI Increase three fold.
- Poverty line rises five fold.
- This mirrors the Urban grain price, showing the dependence of low income households on grain.

Poverty Head-Count Indices in Terms of Income and Expenditure for Urban China

Table 1
National urban poverty rate: 1986 to 2000

	Expenditure measured poverty rate based on		Income measured poverty rate based on	
	upper line	lower line	upper line	lower line
1986	5.34	2.40	2.09	1.10
1987	5.78	2.85	2.21	1.03
1988	6.10	2.92	2.63	1.50
1989	7.09	3.32	2.62	1.59
1990	6.50	3.05	1.91	0.97
1991	6.85	3.41	2.49	1.29
1992	10.12	5.12	3.62	1.72
1993	14.91	7.50	5.33	2.30
1994	12.88	6.94	5.11	2.63
1995	13.10	6.71	5.55	2.57
1996	12.88	6.20	4.94	2.28
1997	13.55	6.83	5.28	2.48
1998	13.06	5.50	4.83	1.85
1999	12.11	5.04	4.21	1.70
2000	10.19	3.92	3.97	1.71

- Poverty rate is higher in the 1990s than in the 1980s, especially for expenditure-measured poverty
- Causes:
 - need to spend on non-food necessities
 - increase in non-food and food price levels
 - income inequality increased in 1993

Poverty Head-Count Indices in Terms of Income and Expenditure for Urban China

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- large discrepancy between poverty rates measured by income and expenditure
- In most countries, the income distribution is more unequal than the expenditure distribution and, poor households normally spend more than they earn
- Thus, the poverty head-count measured in income is usually higher than if it is measured in expenditure.
- In China it is the opposite.
 - under-reporting of income by poor households in other countries.
 - The Chinese high desire to save.

CPI adjustment under-represents poverty



(a) Poverty rate measured in terms of income using 1986 upper poverty line and deflated by different price indices: 1986-2000

Relationships among poverty, inequality, and income

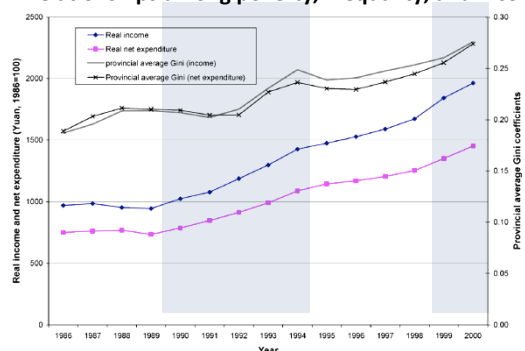


Fig. 6. Changes in income, expenditures, and Gini coefficients: 1986 to 2000.

Table 3

Decomposition of poverty rate changes

	1986–1990	1990–1993	1993–1997	1997–2000
<i>Expenditure</i>				
Predicted change in log poverty	0.42	0.40	0.11	−0.45
Log(real income)	−0.16	−0.71	−0.55	−0.65
Log(Gini)	0.14	0.15	0.11	0.14
Log(saving rate)	−0.01	0.02	0.02	0.08
Log(food price index)	0.28	0.61	0.30	−0.25
Log(meh) ^a	0.12	0.27	0.20	0.18
Time trend	0.05	0.04	0.05	0.04
<i>Income</i>				
Predicted change in log poverty	0.20	0.55	0.14	−0.51
Log(real income)	−0.31	−0.77	−0.61	−0.72
Log(Gini)	0.23	0.28	0.23	0.29
Log(saving rate)	−0.01	0.00	0.01	0.02
Log(food price index)	0.21	0.73	0.33	−0.28
Log(meh)	0.16	0.37	0.27	0.25
Time trend	−0.09	−0.07	−0.09	−0.07

^a The expression meh stands for the budget share of medical, education, and housing expenditure.

6.3 Power, Social Structure and Inequality

❖ Power as an endowment.

- ❧ Identity
- ❧ Political power
- ❧ Social capital

Result 1: Poverty

- ❖ Enlarging urban-rural inequality and the difficulty in rural poverty reduction.
- ❖ Urban poverty and the marginalization of migrants.

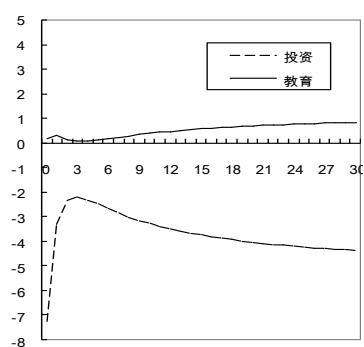
Result 2: Social Mobility

- ❖ US:1979-1988 (*Frenze, 1996*)
 - ☞ 14.2% of the upper 20% people and 64.7% of the bottom 20% remained.
- ❖ Rural China:1978-1989 (*Nee, 1994*)
 - ☞ 40.3% of the upper 20% people and 35.1% of the bottom 20% remained.
- ❖ More mobility in China (1990-1995) than in US (1993-1998)(*Khor,2005*)

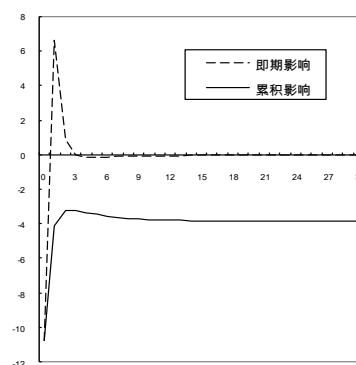
Result 3: Inequality and Growth

- ❖ (1) Credit-market imperfection (*Galor and Zeira, 1993; Fishman and Simhon, 2002*)
- ❖ (2) Political economy (*Alesina and Rodrik (1994), Persson and Tabellini (1994), Benabou (1996)*)
- ❖ (3) Social and political unrest (*Benhabib and Rustichini (1996)*)
- ❖ (4) Inequality and fertility(*De la Croix and Doepke, 2004*)

Inequality, Education and Investment



Inequality and Growth



Inequality and Consumption

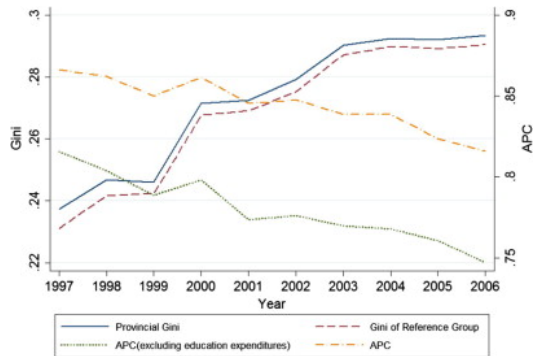


Fig. 1 Average propensity to consume and income inequality.

Ye Jin, Hongbin Li, Binzhen Wu, "Income inequality, consumption, and social-status seeking", *Journal of Comparative Economics*, Volume 39, Issue 2, 2011, 191 - 204

Inequality across Regions and Age Groups

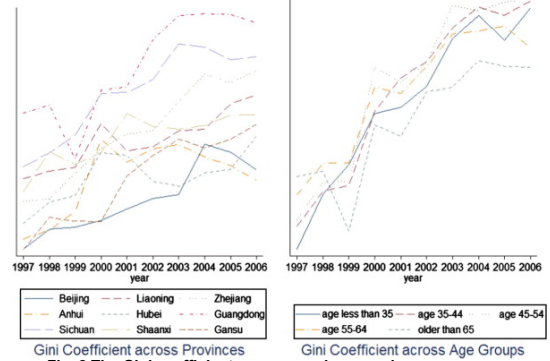


Fig. 2 The Gini coefficient across provinces and age groups.

Ye Jin, Hongbin Li, Binzhen Wu, "Income inequality, consumption, and social-status seeking", *Journal of Comparative Economics*, Volume 39, Issue 2, 2011, 191 - 204

Comment

- ❖ Narrowing inequality not only for justice
- ❖ Inequality does not necessarily enlarge as the economy develops.
- ❖ Inequality does not automatically narrow as the economy develops further.

Readings

- ❖ Ray Brooks and Ran Tao, 2003, "China's Labor Market Performance and Challenges", IMF working paper.
- ❖ Hertel, Thomas and Zhai Fan, "Labor Market Distortions, Rural-Urban Inequality and the Opening of China's Economy", Purdue University, Working Paper.
- ❖ Yao, Shujie and Zongyi Zhang, 2001, "On Regional Inequality and Diverging Clubs: A Case Study of Contemporary China," *Journal of Comparative Economics*, 29, 466-484.
- ❖ Xin Meng, Robert Gregory and Youjuan Wang, **Poverty, inequality, and growth in urban China, 1986-2000**, *Journal of Comparative Economics*, Volume 33, Issue 4, December 2005, Pages 710-729. (*****)

Discussion

- ❖ Topic 1: Will China's inequality increase?
- ❖ Topic 2: How to decrease the inequality in China? Could you give some suggestions based on experience from your own country?

Case 1 - High-End Hainan Island Tourism Projects Highlight China's Wealth Gap

- ❖ <http://au.ibtimes.com/articles/337995/20120507/hainan-island-tourism-projects-highlight-china-s.htm>
- ❖ Money has poured into prime seafront property to build five-star hotels, lush golf courses and marinas for private yachts, generating an investment-led boom that has seen the island's economy grow an average 35 percent faster than the rest of the country in the three years since the government campaign began.

High-End Hainan Island Tourism Projects Highlight China's Wealth Gap

- ❖ But, for the 8.6 million population, the outcome has been inflation and yawning income disparity as family farms that once generated earnings of about 20,000 yuan (\$3,174) a year are sold off for luxury homes that cost 150,000 yuan per square meter.

Wealth Gap

- ❖ Sanya is a potent example of how speculative funds have not only priced local people out of the real estate market but are fuelling home prices in some cities even as Beijing's property tightening policies help cool prices elsewhere.

Wealth Gap

- ❖(Reuters) - A central government plan to create a high end tourist industry on the tropical Hainan island has delivered a much -anticipated surge in economic growth, but it has also widened the wealth gap between rich and poor that Beijing was trying to close.

Wealth Gap

- ❖This is a problem China has nationally - how to promote growth and investment that spreads wealth to local residents, not the already rich, or returns it to local government coffers.
- ❖A widening wealth gap is a critical risk for China's Communist government which stakes its claim to single party power on the promise of social stability and steady economic growth. Fail in that and the government risks triggering unrest.

Case 2: Inequality in China O brother, where art thou?

- ❖http://www.economist.com/blogs/freeexchange/2011/05/inequality_china
- ❖This rising inequality might not be worrying if it reflected an increasingly dynamic, meritocratic society, rewarding greater effort or ability. But the authors estimate that 63% of this inequality in *outcomes* was due to inequality of *opportunity*.

Case 2: Inequality in China O brother, where art thou?

- ❖In their 2010 paper, Messrs Zhang and Eriksson take account of a number of circumstances beyond the individual's control, including the income, education and employer of a person's parents; as well as that person's place of birth and gender. They find that having richer parents helped a person's prospects (a 10% increment in parental income was reflected in a 4.5% income boost for their offspring) and having parents who were employed by the state helped a lot. Parental education, on the other hand, was no help whatsoever. In these provinces, where your parent works matters more than where he went to school.

Case 2

- ❖ Not every parental influence can be observed, distinguished and measured, however. So in a recent working paper, the two authors look at an alternative indicator: namely, the correlation between one brother's income and another's. This fraternal comparison is a good "omnibus" measure of the weight of family and community influence, according to Mr Eriksson. Two children brought up by the same people, under the same roof, in the same neighbourhood, will share many of the same circumstances of birth and background. If these things matter greatly in a society, they will govern the life chances of both brothers, resulting in a tight correlation in their incomes. If, on the other hand, family background matters little, the fraternal correlation will be low.

Case 2

- ❖ In a 2000 paper co-authored by Mr Eriksson, he and his colleagues found that the correlation was much higher in the US (0.43) than in the Nordic countries (0.14 to 0.26). In China, the correlation is higher still: 0.57. To put that in context, the authors argue that knowing what a person's brother earns gives you a better guide to a Chinese person's income than economists are normally able to obtain from knowing how many years of schooling and work experience a person has under his belt.

Case 3: Rising income inequality a threat to Asia's Growth

- ❖ (Reuters) - Developing Asia's rapid growth in recent years has given rise to a widening rich-poor divide that threatens to undermine the region's growth and stability, but governments can address the problem via shifts in spending priorities, the Asian Development Bank said.

Rising income inequality a threat to Asia's Growth

- ❖ The region must spend more on education and health, create quality jobs and invest in infrastructure to reduce imbalances between developed and lagging rural areas so as to prevent social problems that can lead to inefficient populist policies, the Manila-based ADB said on Wednesday.
- ❖ <http://in.reuters.com/article/2012/04/11/asia-economy-adb-idINDEE83A00U20120411>