

Inequality and the Imperative for Inclusive Growth in Asia

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Developing Asia's rapid growth rates that have contributed to a remarkable decline in the incidence of poverty have also been accompanied by rising income and expenditure inequalities and persistence of high levels of nonincome inequalities. These inequalities could be traced to various dimensions of unevenness in the growth process. In turn, the unevenness arises from policy factors as well as from structural transformation associated with growth. Further, unevenness arises from constraints to access to public services and inputs like land and credit. To address these causes of inequalities, the paper advocates a strategy of inclusive growth. This strategy rests on three anchors, i.e., expanding opportunities, broadening access to opportunities, and social protection that acts as a safety net and a springboard. These anchors reinforce each other to facilitate a process of allowing all members of society to participate in, and contribute to, the growth process on an equal footing regardless of their individual circumstances. Public policy to address the disadvantages of circumstances and thereby ensure an even playing field for all is the bedrock of inclusiveness

I. INTRODUCTION

Stellar growth rates leading to a spectacular decline in the incidence of poverty in developing Asia showcase the region's development success over the last 10 years. As many developing Asian countries enter the next phase of their development stage, the emergence of two faces of Asia is a cause for economic, social, and political concern. Responding to the opportunities of globalization, technological change, economies of scale, and competition, a "shimmering" Asia is emerging where a small segment of the population is benefiting from an extraordinary boom. In sharp contrast, large segments of the population are stuck in a "shivering" Asia with low wages, little or no social services, and little opportunity for improved mobility. These two faces of Asia are both a beacon of hope and a symbol of despair. Merging these two faces toward a gleaming Asia is the development challenge over the near and medium term and is the focus of this paper.

The key messages of the paper are as follows. Rising income inequalities and the persistence of unacceptably high levels of nonincome inequalities pose a

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clear and present danger to Asia's sustained progress. Inclusive growth that focuses on both creating opportunities rapidly and making them accessible to all including the disadvantaged and the bypassed is a necessary but insufficient condition for reducing inequality outcomes. Inclusive growth that focuses on understanding and addressing the causal factors underpinning inequality outcomes is process-oriented and is primarily concerned with *ex ante* policy formulation. *Ex post* measurement of inclusive growth assesses the extent and degree of inclusiveness attained. Finally, inclusive growth needs to address economic, social, and political constraints in generating opportunities, as well as ensuring equal access to them.

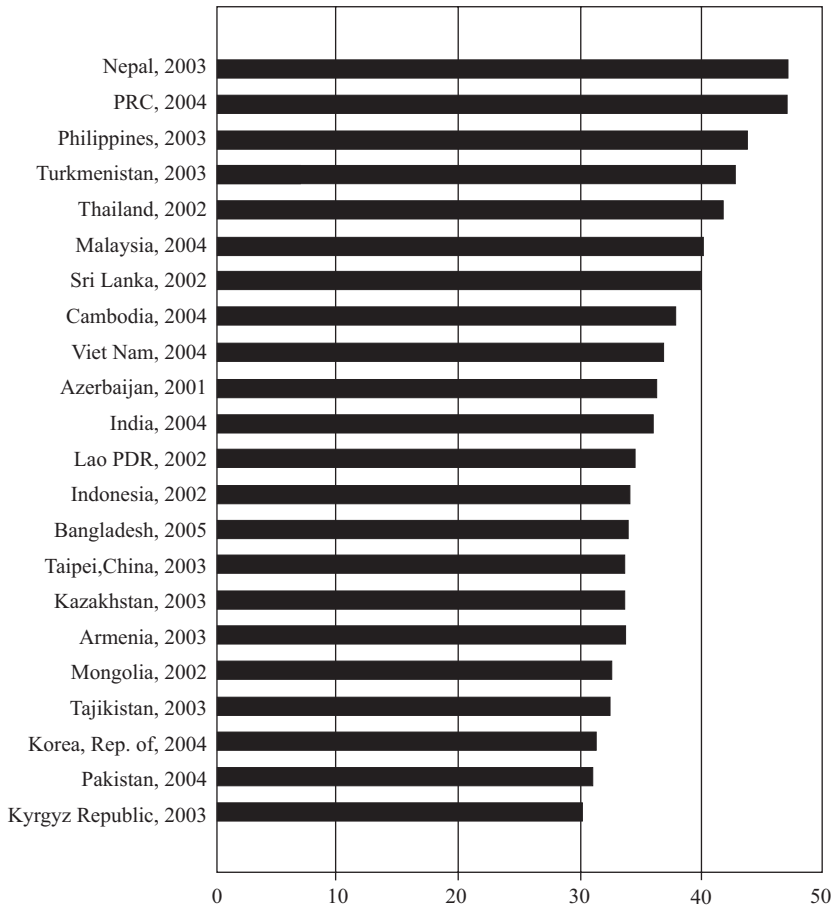
II. INCOME AND NONINCOME INEQUALITIES IN ASIA¹

A. Inequalities are Rising

Figure 1 presents estimates of the Gini coefficient, a popular measure of relative inequality. Seven countries have Gini coefficients of around 40 or more; the remaining countries have Gini coefficients of 30 to 40. These current levels of inequality represent increases over the last 10 years (see Figure 2). An increase in inequality is registered for a majority of economies. The increases in inequality in Bangladesh, Cambodia, People's Republic of China (PRC), Nepal, and Sri Lanka are noteworthy.

¹This section draws heavily from the special chapter "Inequality in Asia" in *Key Indicators 2007* (Asian Development Bank 2007a).

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

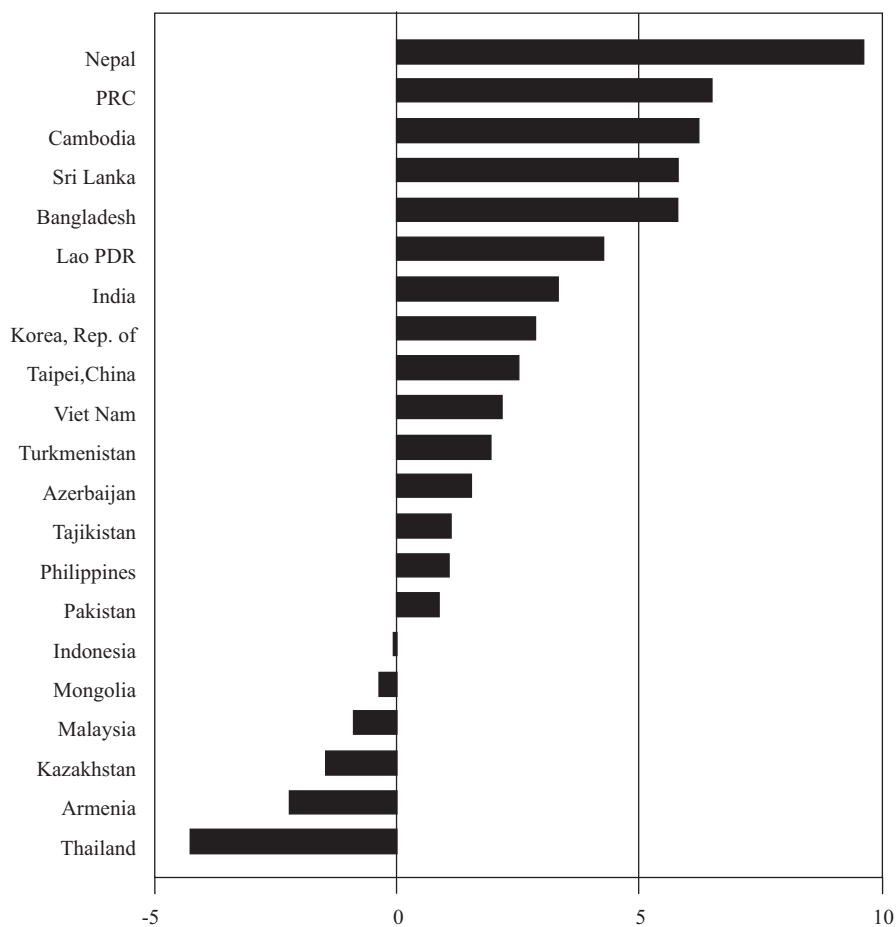


Note: Pre-household income distributions are used for Korea (urban wage and salaried households only) and Taipei, China. Per capita expenditure distributions are used for the rest.

Source: ADB (2007).

Moving to an absolute measure of inequality provides an even more compelling story. Figure 3 describes changes in per capita expenditure levels of the top 20 percent and bottom 20 percent. The bars represent the level changes while percentage changes are provided in parentheses. The richest 20 percent have been experiencing the largest gains in expenditures in all the economies depicted in the figure. This is also the case for those economies where the bottom 20 percent registered a higher growth rate in per capita expenditure than the top 20 percent (for example, Indonesia).

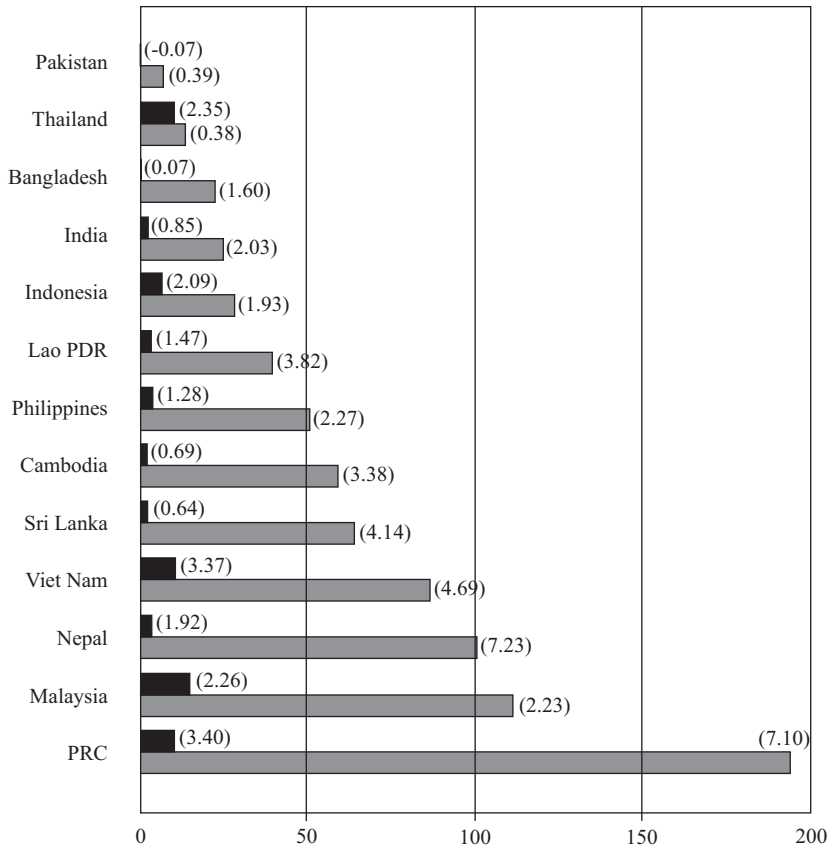
Figure 2. Changes in Gini Coefficient for Expenditure/Income Distributions, 1990s–2000s (percentage points)



Note: Years over which changes are computed are as follows: Armenia (1998–2003); Azerbaijan (1995–2001); Bangladesh (1991–2005); Cambodia (1993–2004); PRC (1993–2004); India (1993–2004); Indonesia (1993–2002); Kazakhstan (1996–2003); 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 Korea and Taipei, China; expenditure distribution for the rest.

Source: ADB (2007).

Figure 3. **Changes in Per Capita Expenditures, Bottom 20% and Top 20%, 1990s–2000s** (in 1993 PPP dollars)



Note: Years over which changes are computed are as follows: Bangladesh (1991–2005); Cambodia (1993–2004); PRC (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.

Source: ADB (2007).

The picture that emerges is that in a majority of Asian countries, inequality has increased. However, this is not a story of the rich getting richer and the poor getting poorer. Rather, the rich are getting richer faster than the poor. This point is important because while economists focus on relative inequality, politically and socially, absolute inequalities can get considerable attention.

Inequalities in income and expenditure represent only one dimension of inequality. Inequalities in health, education, and economic assets such as land could be high even in countries where income inequality is not high. As an example, India and Pakistan, which do not have high income inequalities, have very unequal outcomes in terms of how severely underweight children are

distributed across rich and poor households. In India, 5 percent of the children are severely underweight among the richest 20 percent of households. In the case of the poorest 20 percent of households, this share is 28 percent. Education outcomes show a similar pattern, with Bangladesh, India, Nepal, and Pakistan having very unequal education attainments.

Low levels of income inequality can also coexist with high levels of inequality in asset ownership and access to infrastructure services. The distribution of land, one of the most important economic assets in developing Asia, is heavily concentrated. This is particularly true in the South Asian countries where income/expenditure inequalities are low. A similar phenomenon is seen in terms of access to public services like clean water, health facilities, sanitation, electricity, and schools. Banerjee, Iyer, and Somanathan (2007) show that a great proportion of the population in lagging subnational regions in Asian countries have little or no access to these public services. This is especially true for South Asian countries like India and Nepal.

The description of inequalities in developing Asia highlights three issues. First, income/expenditure inequalities are rising in many Asian countries. Second, low levels of income/expenditure inequality can coexist with high levels of inequality in important dimensions of well-being that could circumscribe the capacity of people to participate in productive economic activities. Third, a concentration of assets implies that for the economically disadvantaged, potential economic opportunities may be difficult to seize.

B. Drivers of Rising Inequalities

The key factor responsible for increases in inequality appears to be unevenness in growth. Three dimensions of uneven growth seem especially pertinent in accounting for increases in inequality in many parts of the region. First, growth has been uneven across subnational locations (i.e., across provinces, regions, or states). Second, growth has been uneven across the rural and urban sectors. Finally, 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 the bottom. In particular, the growth of incomes has tended to be the highest for the best educated.

One can ask what policy factors are behind these patterns of uneven growth. The policy factors are complex. However, some broad themes emerge. First, there has been a relative neglect of the agriculture sector by policymakers. While economic development entails a move off the farm to industry and services, deficiencies in public investments in agriculture, and the rural economy more generally, has been problematic precisely because the productivity of agriculture determines the standards of living of so many people in Asia. Even

today, a majority of the labor force of many Asian countries, especially its largest ones, is to be found engaged in agriculture.

Second, the interplay between market-oriented reforms, globalization, and technology has played a role in unequal growth. In several countries, for example, dismantling state-owned enterprises has been part and parcel of market-oriented reforms. Typically, state-owned enterprises have had fairly compressed wage distributions. As the importance of the private sector has grown, it would be natural to find increases in wage inequality.

Similarly, globalization—or increased international integration—has tended to benefit certain subregions within countries over others. For example, in the PRC, there is a general consensus among analysts that sharpening income disparities between coastal and interior regions have been driven by the countries' increased openness. The costs of shipping goods from the coastal regions to major international trade centers is far lower than that of shipping goods from interior regions. The lowering of barriers to trade has probably also reduced the bargaining power of workers relative to capital. This has happened on account of the fact that capital and skilled workers are far more mobile across countries than relatively unskilled workers.

Finally, new technologies display a bias in favor of skills. The same is true of foreign direct investment. Either way, the demand for skilled workers has increased faster than the demand for unskilled workers. The result has been faster growth of wages among the skilled. Since these are precisely the group of workers who would have been better paid to begin with, inequality would increase.

Turning to inequalities in access to public services, a major issue is the rapid decline in the effective delivery of these services (ADB 2006, World Bank 2006b, Tandon and Zhuang 2007). A deterioration of public ethics, public institutions, and public administration have together resulted in significant leakages of public expenditures that do not reach the target groups. As a result, schools with errant teachers, measles immunization that never reach rural areas, and child nutrition programs that are not delivered are commonplace in many Asian countries. A lack of accountability on the parts of governments to deliver public social services is widespread.

Land reforms that never took place are at the root cause of inequality in land or access to it. Lack of political will and/or elite capture of political institutions make meaningful land reform exceedingly difficult in many countries. Related to inequality in land or access to it is the lack of access to credit that compounds the problem. Debt, penury, pauperisation all go together.

C. Inequality Matters

An influential view in the development community is that greater inequality is inherent in the growth process (Lewis 1983). In the process of structural transformation and growth, certain regions in certain sectors can be expected to benefit first. This would cause some increase in inequality initially. As growth proceeds, more regions and sectors undergo beneficial transformation and inequality declines. This view is consistent with the famous “Kuznets curve” where inequality first rises and then falls with economic growth.

There are two problems with this viewpoint. First, the empirical evidence for the “Kuznets curve” is weak. In the Asian context, Republic of Korea and Taipei, China clearly demonstrated in their rapid period of growth between the 1970s and 1990s that a rapid and sustained increase in inequality is not an inevitable result of high economic growth. Their income-based Gini coefficients never reached 40 during their period of rapid growth. In fact, they declined over some periods of high growth. Second, there are compelling reasons to believe that high levels of inequality may in fact hinder future growth. The specific mechanisms work through wealth effects and political economy channels.

People with little wealth or low incomes find it difficult to invest in wealth- or income-augmenting activities. This is compounded by imperfections in financial markets that seriously constrain the ability of otherwise credit-worthy individuals to borrow to finance investments in education or business opportunities. Underinvestment by people with little wealth or low income impacts negatively on growth.

An alternative way of looking at the same problem has been recently enunciated (Banerjee 2007). Against the phenomenon of the rich getting richer faster than the poor, it becomes harder for the poor to compete with the rich for limited resources including capital. With too much capital concentrated in the hands of the rich, allocative inefficiency in investment will impact negatively on growth.

The political economy considerations operate at three different levels. First, high levels of inequality lead to pressures to redistribute, which, if executed through a distortionary manner, may lower growth. Second, the persistence of inequalities reinforces the capture of political, economic, and legal institutions by an elite who ensures that the benefits of public policy, public investment, and public services accrue to the most favored. The capture of political power by an elite that leads to political inequality aggravates the initial inequality in endowments and opportunities (Bourguignon, Ferreira, and Walton 2006; Rajan and Zingales 2007). Third, the call for redistribution and sharing political power can range from peaceful and prolonged street demonstration to violent civil war. In its extreme form, these tensions could lead to armed conflict as has currently occurred in Nepal (Murshed and Gates 2005). A lack of opportunities as

indicated by higher poverty rates or lower literacy rates has been found to be significantly associated with a higher intensity of violent conflict (Do and Iyer 2006).

Clearly, rising inequalities in Asia pose a clear and present danger to social and political stability, and therefore the sustainability of the growth process itself.

III. INCLUSIVE GROWTH: A CONCEPTUAL FRAMEWORK

The discussion on the nature and drivers of inequalities points to three noteworthy issues. First rising inequalities could be an inherent by-product of the growth process, and knee-jerk reactions to eliminate increases in inequalities may stifle the growth process itself. Second, lack of access to basic public services, credit, and risk-mitigating instruments perpetuate the lack of capabilities and opportunities for large sections of society. Third, the marginalization and bypassing of significant sections of society could undermine the sustainability of growth.

Inequality is an outcome, and how it should be addressed must begin with identifying the drivers of inequality. Inequalities can be associated with efforts that respond to market incentives. Inequalities also arise from lack of access to social services, geography, and social exclusion that are related to circumstances. An individual's circumstances such as religious background, parental education, geographical location, and caste (in India) are exogenous to and outside the control of the individual, for which he or she should not be held responsible. Inequalities due to differences in circumstances often reflect social exclusion arising from weaknesses of the existing systems of property and civil rights, and thus should be addressed through public policy interventions. On the other hand, an individual's efforts represent actions that are under the control of the individual, for which he or she should be held responsible. Inequalities due to differences in efforts reflect and reinforce market-based incentives needed to foster innovation, entrepreneurship, and growth. Incentives should not be disregarded.

Differences in outcomes, such as differences in incomes across individuals reflect some combination of differences in efforts, i.e., the set of actions that are under the control of the individual; and differences in circumstances, i.e., the factors, including economic, social, or biological ones that are outside the control of the individual (Roemer 2006).

The inequality that results from differences in efforts are acceptable and even desirable to the extent that they reflect the incentives that an economy provides to its citizens for working harder, looking out for new opportunities, and taking the risks entailed in seizing them. However, inequalities resulting from differences in circumstances are not only ethically unacceptable, they result in wasted productive potential and misallocation of resources. Disadvantages of

circumstances are doubly undesirable. In addition to the disadvantages that they create as when access to education, health care, and job opportunities is unevenly distributed, they can create additional disadvantages by negatively influencing the amount of effort that an individual in unfortunate circumstances is willing to make. Inequality of opportunities caused by circumstance-based inequalities should be the target of public policies.

The distinction between inequality outcomes resulting from efforts and circumstances provides the basis for the definition and rationale for inclusive growth. Inclusive growth is growth that not only creates new economic opportunities but also one that ensures equal access to the opportunities created for all segments of society including the disadvantaged and the marginalized. Growth is inclusive when it allows all members of a society to participate in, and contribute to, the growth process on an equal footing regardless of their individual circumstances (Ali and Zhuang 2007).

The importance of equal access to opportunities for all lies in its intrinsic value as well as instrumental role. The intrinsic value is based on the belief that equal access to opportunity is a basic right of a human being and that it is unethical and immoral to treat individuals differently in access to opportunities. The instrumental role comes from the recognition that equal access to opportunities increases growth potential, while inequality in access to opportunities diminishes it and makes growth unsustainable, because it leads to inefficient utilization of human and physical resources, lowers the quality of institutions and policies, erodes social cohesion, and increases social conflict.

The differentiation of inequalities arising from efforts from those arising from circumstances leads to an important distinction between “inequalities of outcomes” and “inequalities of opportunities” (World Bank 2001a and 2006a). Inequalities of opportunities are mostly due to differences in individual circumstances, while inequalities of outcomes such as incomes reflect some combination of differences in efforts and in circumstances. If policy interventions succeed in ensuring full equality of access to opportunities, inequalities in outcomes would then only reflect differences in efforts, hence could be viewed as “good inequalities” (Chaudhuri and Ravallion 2007). On the other hand, if all individuals exert the same level of efforts while policy interventions cannot fully compensate for the disadvantages of circumstances, the resulting inequalities in outcomes are “bad inequalities.” While these two extreme cases are useful for analytical purposes, in reality, inequalities in outcomes would consist of both good or desirable, and bad or undesirable inequalities. Equalities in opportunities that emphasize eliminating circumstance-related bad inequalities so as to alleviate inequalities in outcomes are at the core of inclusiveness and at the heart of an inclusive growth strategy.

The recognition that equality of opportunities need not necessarily translate into equality of outcomes, i.e., lower levels of inequality achieved is important.

Inclusive growth with its simultaneous focus on rapidly expanding opportunities and ensuring equal access to these opportunities results in an inherent tension. The tension arises from the coexistence of effort-based or good inequality and circumstance-based or bad inequality. An increase in effort-based inequality could swamp out the decline in circumstance-based inequality resulting from equalizing access to opportunities, leading to an overall increase in inequality outcomes. It needs to be recognized that even in this case, a with and without counterfactual would suggest that inequality would be lower with an inclusive growth strategy as compared to the without an inclusive growth strategy scenario. As a consequence, inclusive growth is a necessary but not a sufficient condition for lower inequality.

The distinguishing feature of the inclusive growth process is that it focuses attention on understanding the causal factors behind inequality outcomes and then addresses the causal factors. Inclusive growth depends on average opportunities available to the population and how opportunities are shared among the population (Ali and Son 2007b). Whether growth is inclusive depends on the contribution of increasing average opportunities in society with distribution of opportunities constant, and the contribution of changes in distribution when average opportunities do not change. As long as the combined effect is positive, growth would be inclusive. With inclusive growth, there would be improvements in social welfare. Thus, as an *ex ante* instrument of policy formulation, the concept of inclusive growth provides a powerful analytical tool that links the diagnostics of inequality to policy formulation, which in turn addresses the drivers of inequality. The tradeoffs between growth of average opportunities and their distribution, if any, are factored in at the outset.

Public policy to address the disadvantages of circumstances and thereby ensure an even playing field for all is at the core of inclusiveness (Roemer 2006). Market and government failures that result in a lack of or inadequate access to basic public goods and services will need to be addressed in a responsible and accountable manner (ADB 2006).

IV. INCLUSIVE GROWTH: A STRATEGY

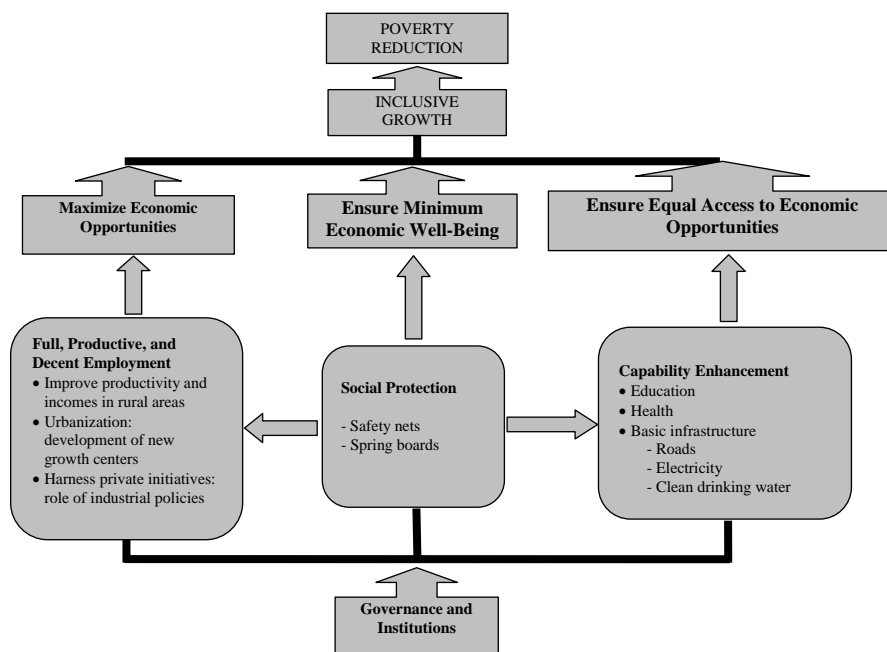
In terms of opportunities and access to them, labor market outcomes in Asian countries tell a powerful story. Four features are noteworthy (Felipe and Hasan 2006). First, corresponding to rapid output growth, employment growth has been far lower in recent years. Second, in both relative and absolute terms, the differences in real wages between the bottom and top quintiles of the labor force in urban areas increased significantly over the last two decades. At the same time, rural–urban differentials in real wages have also widened. Third, employment in the informal sector where productivity levels and wages are low is either on the rise or persistently high. Last, the nature of employment in the

formal sector, which has been historically associated with regular contracts and job security, is changing toward that which is more characteristic of the informal sector. These features of labor market outcomes are contributing factors, albeit very important factors, of lagging opportunities and lack of access to opportunities in Asia. This has led to an advocacy for countries to adopt the goal of full, productive, and decent employment (Felipe and Hasan 2006, Felipe 2007). Creating opportunities is the first pillar of inclusive growth.

Equalizing opportunities means that the opportunities generated by growth are available to be shared across the entire spectrum of the population including by those who are less well-off. Equalizing access to economic opportunities is multidimensional, i.e., addressing the disadvantages of circumstances. In particular, strengthening human capabilities enable individuals to qualify for productive and decent employment. Ensuring equal access to economic opportunities is the second pillar of inclusive growth.

There is increased recognition that even if access to opportunities was equalized, there will always be some chronically poor who, for a variety of reasons, will not be able to participate in and benefit from the opportunities provided by the growth process. Social protection through the provision of social safety nets will be required for the chronically poor to enable them to survive with a modicum of dignity. Further, social protection systems could enable vulnerable individuals to invest in potentially high-return activities. In this way, social protection policies not only act as safety nets but also as springboards to enable vulnerable households to break out of the poverty trap, by allowing them to invest in building human capital and to make profit-maximizing decisions (World Bank 2001b). Social protection constitutes the third pillar of inclusive growth.

The three pillars of inclusive growth are integrated in this flow chart (Figure 4):

Figure 4. **Three Pillars of Inclusive Growth**

The flow chart has to be supplemented by the measurement of inclusive growth and how it is related to poverty reduction. Given that what cannot be measured cannot be managed, inclusive growth needs to be measured. Conceptually, measurement has to focus on average opportunities and distribution of opportunities (Ali and Son 2007a). Measurement of inclusive growth can be carried out for individual components, e.g., employment, access to education, access to health facilities, etc. The advantages of measuring the inclusiveness of growth by component is that the extent of progress can be determined individually before decomposing the change by major drivers, which are needed to design policy interventions.

Turning to poverty reduction whose measurement depends on the poverty line, mean expenditure of household expenditure distribution, and inequality of the distribution, the focus is on outcomes. Basically, getting people just below the poverty line to cross over has been the implicit focus of most development practitioners. Issues on the severity of poverty and poverty gaps associated with the level of inequality receive less attention (Son 2007).

An inclusive growth strategy encompasses the key elements of an effective poverty reduction strategy and, more importantly, expands the development agenda. A poverty reduction strategy based on a single and absolute income criterion ignores the issue of inequalities and the risks associated with them. In

contrast, an inclusive growth strategy addresses circumstance-related inequalities and their attendant risks. Inclusive growth is not based on a redistributive approach to addressing inequality. Rather, it focuses on creating opportunities and ensuring equal access to them. Equality of access to opportunities will hinge on larger investments in augmenting human capacities, including those of the poor, whose main asset—labor—would then be productively employed.

Overall, inclusive growth with its focus on the process of expanding opportunities will result in more effective poverty reduction. In particular, with its focus on addressing inequalities, inclusive growth will address issues of poverty gaps and the severity of poverty, thereby enlarging the poverty reduction agenda. The more important point is that inclusive growth is concerned with the overall welfare of society, which includes the poor.

V. CONCLUSION

Merging the “shimmering” and “shivering” faces of Asia into a progressively prosperous region, i.e., a gleaming Asia, is the development challenge over the next generation. While high and sustainable growth are absolute requirements, the fruits of growth must be shared more equally. Asia’s movement from low, to medium, to high levels of income and nonincome inequalities is worrisome as social and political tolerance to growing inequalities is getting lower. The sustainability of growth could thus be undermined. It is in this context that inclusive growth with its focus on rapidly expanding opportunities and ensuring equality of access to these opportunities is desirable on both intrinsic and instrumental considerations.

The thrust of inclusive growth is on the positive, emphasizing expanding opportunities and capability enhancement at the economywide and household levels. The directional change is from entitlement to empowerment. Circumstance-based disadvantages must be addressed by public policy interventions that guarantee an even playing field so that people can be empowered to lift themselves up by their bootstraps to exploit the opportunities generated by rapid and sustained growth.

While the adoption of an inclusive growth strategy is a natural evolution in Asia’s development process, the reform agenda required to effect it is complex and ambitious. Reforms relating to governance, institutions, and policies that address both economic and political inequality will need to be addressed simultaneously. An enlightened and an active state will be needed to partner with the private sector and civil society in the pursuit of shared prosperity.

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