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How much should we care about changing income inequality in the course of economic growth?

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Abstract

This paper asks how much we should care about changes in Lorenz curves and standard inequality measures when economic growth takes place. I conclude that these changes are of some importance but that other aspects of inequality and poverty are more important.

Keywords: Inequality; Poverty; Pro-poor growth

1. Introduction

In December 2006, the new President of Chile, Michelle Bachelet, convened a workshop on economic inequality. Chile has achieved a 4.2% annual rate of economic growth over the last 30 years, an enviable record indeed for a Latin American country. In the course of this economic growth, indigence and poverty have been falling continuously. Yet, Chile has one of the most unequal distributions of income in Latin America, which is the highest inequality region in the world, and income inequality in Chile remains, in the President's words, "stubbornly stagnant." This fact motivated her to convene a workshop on the question of how much should we care about income inequality. This paper, based on the keynote speech I delivered at that workshop, attempts to answer this question, not just for Chile but for the developing countries more generally.

Four aspects of income distribution may be distinguished. *Income inequality* involves comparisons between some incomes and others.[1] *Poverty* analysis entails people identifying who is

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[1] This paper is limited to a discussion of relative inequality. Relative inequality is concerned with income *ratios*, not income *differences.* Thus, if all incomes grow by the same percentage, relative inequality is unchanged.

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poor and then quantifying the extent of poverty in the population.[2] *Income mobility* is about the changes in income or economic position when the same are followed over time.[3] Finally, *economic well-being* studies ask, when is one income distribution better than another?[4]

This paper discusses how much attention the inequality aspect of income distribution should receive as compared with the other three aspects. I begin by presenting data on poverty and inequality in the world at present and how these aspects of income distribution have changed in the course of economic growth. I then present my own views on the relative importance of inequality and poverty and then proceed to the title question.

2. What we know about how various aspects of income distribution change in the course of economic growth?

An estimated 1.1 billion people in the world live on less than one U.S. dollar per person per day in purchasing power parity (PPP) terms, and another 1.6 billion people live on between one and two U.S. dollars per person per day (World Bank, 2005). Thus, nearly half of humanity (44%) are absolutely poor using this very modest poverty line. The number of people in poverty has changed little over the last 10 years. What has changed is the number of people *not* in poverty – about one billion more of them – and therefore the proportion of people in poverty has fallen (International Finance Corporation, 2000). Virtually all of these people live in the developing countries, and hence this paper focuses on the developing world.

Let us turn now to income inequality.[5,6] The most commonly used measure of income inequality is the Gini coefficient.[7] The Gini coefficient of world income inequality has been estimated by various researchers to be between 0.62 and 0.70. To give a sense of how high this is, the United Nations reports inequality figures for 177 countries, and only 1 (Namibia) has a Gini coefficient as high as the Gini coefficient for world inequality (United Nations, 2005, Table 14).

As for changes in income inequality, we can look both at world income inequality and at income inequality within countries. Concerning world inequality, by most accounts, it has been falling since 1990 and perhaps before (Milanovic, 2005; Wolf, 2004). This is because of the rising incomes throughout the income distribution in China and India. Milanovic (2005) presents a comprehensive survey of this literature. As for within-country inequality in the developing world,

[2] This paper addresses absolute poverty, which is based on a constant real poverty line, as is used internationally by the World Bank and by individual countries such as the United States. By contrast, relative poverty is based on a changing real poverty line – for example, in Europe, where the European Union identifies as poor those whose incomes adjusted for household composition fall below 60% of the median.

[3] Six different notions of income mobility are used in the literature. They are time-independence, positional movement, share movement, directional income movement, non-directional income movement, and mobility as an equalizer of longer-term incomes. See Fields (2001) for a discussion of the first five of these and Fields (2005) for a discussion of the sixth.

[4] "Better" is used here in either of two senses: (1) the participants face better economic prospects in one economy compared with another, or (2) an observer using a particular social welfare criterion judges one income distribution to have higher economic well-being than another.

[5] Throughout this paper, "inequality" refers to relative inequality, i.e., that which is based on ratios rather than differences.

[6] Three concepts of world inequality are used in the literature (Ghose, 2003; Milanovic, 2005). "Inter-country inequality" is the inequality of per-capita GDPs, with each country counting with a weight of one. "International inequality" weights each country's per-capita GDP by its population size. Finally, "world inequality" estimates the distribution of income among persons regardless of their country of origin. It is "world inequality" that is most interesting and that is discussed in the text.

[7] The Gini coefficient ranges from zero to one, higher values signifying greater inequality.