



# Inequality

Now you see it, now you don't

Prakash Loungani

“**T**HE RICH ARE getting richer; the poor are getting poorer.” Typing this popular slogan into Google gives over 34,000 hits. But does it describe the truth? And how much should we worry about inequality?

## Just the facts

Establishing the facts can be difficult because there are three commonly used concepts of income inequality, each with a place in the policy discussion. The concept of inequality that most supports the slogan that “the rich are getting richer . . .” is *cross-country inequality*, which refers to the inequality of *average* incomes. Cross-country inequality measured this way has clearly increased in recent decades, a result Harvard economist Lant Pritchett famously described as “divergence, big time.” Average incomes of the advanced nations have continued to rise, while average incomes at the other end of the income distribution, particularly in many countries in sub-Saharan Africa, have stagnated or fallen.

Does this mean that inequality of incomes within countries has increased? Not necessarily. *Within-country inequality* has indeed increased in many countries but remained stable in many others. This second concept is the difference between the incomes of the rich and the poor *within* a country, typically measured using a Gini coefficient—a statistical construct that ranges between 0 and 1, with lower values indicating greater equality. Gini coefficients in Japan, many European countries, and Canada have been stable over the past couple of decades, ranging between 0.25 and 0.3. In contrast, in other developed countries, the United States being the most notable example, the Gini coefficient has increased to about 0.4 over the past 20 years. Emerging markets and developing countries defy easy characterization. Some, like Korea, which has a Gini of around 0.3, have experienced fabulous growth without increases in their already low inequality. Others, like Brazil, which has a Gini of around 0.6, have experienced slow growth and have not made a dent in already high levels of income inequality.

The third concept—*global inequality*—is a “one person, one vote” approach to measuring inequality of incomes.

This concept focuses on inequality of incomes between *persons* rather than between *countries*. Think of this as the John Lennon definition of inequality because we’re being asked to imagine that there are no countries. Why? Because treating each country as one observation—as under the first concept—gives, say, Lesotho and China the same weight in the calculation of global inequality. But 10 percent growth in China improves the welfare of 1.2 billion people, whereas 10 percent growth in Lesotho, while welcome, betters the lives of only a few million.

When differences in the size of populations across countries are taken into account, the finding is not one of “divergence, big time.” Instead it’s “convergence, period.” The mean of world income distribution has steadily shifted to the right since 1970; in other words, the average global citizen has become richer. World income distribution has also become more equal. However, the equality has come about because of the growth of a few very populous countries such as China, India, and Vietnam. So the finding on convergence is of little comfort not just for people in Lesotho but for many of the 2½ to 3 billion people living in other developing nations.

## Which is the fairest of them all?

Which concept of inequality is the right one? It depends on the purpose. From the perspective of simply describing whether human welfare has increased, *global inequality*, the last of the three concepts mentioned above, may be the most appropriate. It treats the income gain of every individual, whether the person is from China or Lesotho, as equivalent.

But the neglect of countries may not be appropriate if the purpose is to assess policies that would reduce inequality in the future. Why? The vast majority of people do not leave the country of their birth. Therefore, living standards and the *within-country inequality* of income in the country of their birth matter most to them. It is of little comfort to someone who cannot escape poverty in an African country to learn of the

Concept of income inequality	Cross-country inequality	Within-country inequality	Global inequality
What it measures	Inequality of <i>average</i> incomes across countries	Differences between incomes of the rich and the poor within a country	Differences between incomes of the rich and the poor, ignoring the country to which they belong
What the evidence shows	Divergence	Increasing inequality in many countries (for example, Brazil, China, United States), but low and stable levels in many others (for example, Canada, France, Japan)	Convergence

### Should we worry?

There is a wide spectrum of views on how much one should worry about developments in inequality. At one end of the spectrum, an excessive focus on inequality is considered misplaced: economist Martin Feldstein, for instance, argues that the real problem is “not inequality but poverty.” Over the broad sweep of history, according to this view, economic progress tends to make almost everyone better off. Joseph Schumpeter observed that “the capitalists’ achievement does not consist in providing

robust growth in China and the consequent reduction in global income inequalities.

The *cross-country inequality* measure is useful as an indicator of whether governments in the poorer countries are adopting policies that allow their incomes to catch up with those in richer nations. Economic policies are typically formulated by national governments. That this measure has shown divergence over time suggests that many governments, particularly in Africa, have been unable to adopt welfare-enhancing policies.

### Money isn’t everything

Income is only one measure of well-being. In calculating its Human Development Index, the United Nations uses per capita income, longevity, and literacy as the three critical measures of well-being.

Thanks to medical advances, it has become cheaper to buy an extra year of life in both rich and poor nations. The result has been a convergence in life expectancy among countries. Take the example of Egypt. Comparing its per capita income with that of the United States, Egypt’s progress has not been impressive. But it has made huge gains in life expectancy, both in absolute terms and relative to the United States. Life expectancy in Egypt was only 48 years in 1965, compared with 69 years in the United States. By 1995, Egyptian life expectancy had risen sharply to 66 years, only 9 years below the U.S. figure for that year.

What’s true for Egypt is true for the developing world in general: poorer countries have gained more in longevity than richer countries. This means that calculations based solely on average incomes underestimate the convergence in overall welfare. Taking into account the income gains conferred by the extra years of life reverses the conclusion that there is divergence between the fortunes of rich and poor nations; instead, there is convergence. However, the pace of convergence is quite sluggish; moreover, it may be that the easy gains in life expectancy in developing countries have already been achieved, and further convergence with developed nations may prove difficult.

silk stockings for queens but in bringing them within reach of factory girls. . . .” Inequality that arises from the rich being made better off at a faster rate than the poor is not a problem, says Feldstein, but he admits that “not everyone will agree with me. Some see inequality as so unlovely that they regard increasing the income of the well-to-do as a ‘bad thing’ even if it does not come at anyone else’s expense.”

Indeed, at the other end of the spectrum of views, inequality—particularly the disparity between the incomes of the very rich and the very poor—is considered one of the major failings of capitalism and markets. In a *New York Times Magazine* article last October, Paul Krugman estimated that the top 0.01 percent of U.S. taxpayers, numbering a mere 13,000 households, received more than 3 percent of the country’s income. Likewise, an article in *American Prospect* last January noted that even by the global inequality measure—the third concept discussed earlier—the richest 10 percent of the world’s population had incomes that were 120 times higher than those of the poorest 10 percent in 1990; as a consequence of the evidence on convergence presented earlier, this ratio did drop, but only to 118 by the end of the decade. The dangers of such concentration of income, according to Krugman and others, are that it fosters the formation of oligarchies more interested in preserving their own wealth and power than in fostering societies with equal opportunities for all.

### A matter of choice?

With the spread of democracy, the level of within-country inequality is increasingly a choice that will be made through the electoral process. A country’s level of income inequality is the result of a complex set of forces—historical factors, cultural norms, and the effects of exogenous forces such as trade and technology. But it is also, to a large extent, a policy choice: many of the countries of Western Europe use redistributive policies to achieve a more even distribution of income than there would otherwise be. ■

*Prakash Loungani is Assistant to the Director of the IMF’s External Relations Department.*