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“World Income Inequality and the Poverty of Nations” by Kevin Gallagher

Diverging levels of national income are among dominant features of the contemporary world. While global income and real GDP have risen sevenfold since the end of World War II, and threefold in per capita terms, the gap in incomes between the developed and developing nations continues to widen. Large income disparities can also be seen within both the developed and developing nations.

Conventional economic wisdom has suggested that such trends need not cause alarm. It has been argued that long-term economic growth fueled by globalization in the form of trade booms, mass migrations, and huge capital flows, will solve each of these problems. Across nations, growth will eventually cause a convergence in world incomes. Within nations, economic growth will decrease inequality in the long term. Thus, the world’s policy-makers have had a justification to largely ignore questions concerning inequality in their decision making.

This essay reviews the current trends in income distribution both across and within the nations of the world, then discusses an emerging literature that offers critiques and alternatives of the conventional view. On both theoretical and empirical grounds, the literature reveals that economic growth and equity concerns need not be separated. In fact, it is shown that economic policies that incorporate equity concerns from the outset can be the most successful.

INTERNATIONAL INCOME DISTRIBUTION ACROSS NATIONS

Several years ago, the United Nations Development Program (UNDP) published a much publicized graph of the world’s income distribution, in 1989 with world population on the X axis and GNP per capita on the Y axis. The graph was striking. It showed that the richest fifth of the world’s population received roughly 85 percent of global income, world trade, domestic savings, and domestic investment. Conversely, the poorest fifth of the world’s population received 1.4 percent of global income, 0.9 percent of world trade, 0.7 percent of domestic savings, and 0.9 percent of domestic investment (UNDP, 1992). When combined with a mirror image of itself, this graph this information appeared to presented as a champagne glass of world income distribution. Later, UNDP put together a similar graph with 1991 data, little changed.

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Is the glass half empty or half full? As figure 9.1 illustrates, using 1997 data the graph (with its reflection)continues to look broad on the top, narrow on the bottom. The nations closest to the bottom are all in Africa. India is the first long straight section of the stem, and China is the second. The glass abruptly widens -that is, incomes get higher -within the top fifth of the world, a region inhabited by the developed industrial countries, oil producing nations, a few of the East Asian “tigers”, and Argentina. Taking the metaphor a bit further, it seems that, about one-sixth of the world’s people actually get to enjoy the champagne, while the rest of the world gets to hold it up!

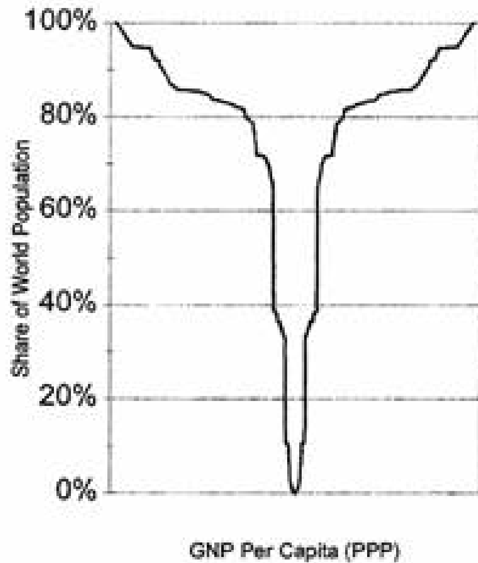

Figure IX.1. World Income Distribution, 1997. On the right half of the X-axis, GNP per capita ranges from 0 to $30,000. The left half of the graph is a mirror image added solely for the sake of appearances. *Source:* UNDP, 1997.

Others would still contend that all this gloom need not be coupled with doom. **Jeffrey Williamson** argues that the late nineteenth and late twentieth centuries are similar in many respects. During the late 19th century there was a relatively large opening in world trade and an increase in mass migration. Such occurrences narrowed the economic distance between rich and poor countries, as seen in Figure 9.2.

Contrasting “New World” with “Old World” nations, Williamson used the ratio of unskilled wages to farm rents, and the ratio of the unskilled wage to GDP per worker hour to explain wage changes in the wage distribution from 1854-1913. The result of the convergence was the result of both a trade boom and mass migrations. Williamson argues that the trade expansion accounted for 10 to 20 percent of the convergence in GDP per worker hour and in the real wage. This is also the explanation given for the fact that wages for unskilled labor rose relative to land rents and skilled wages in poor countries, and rich countries.

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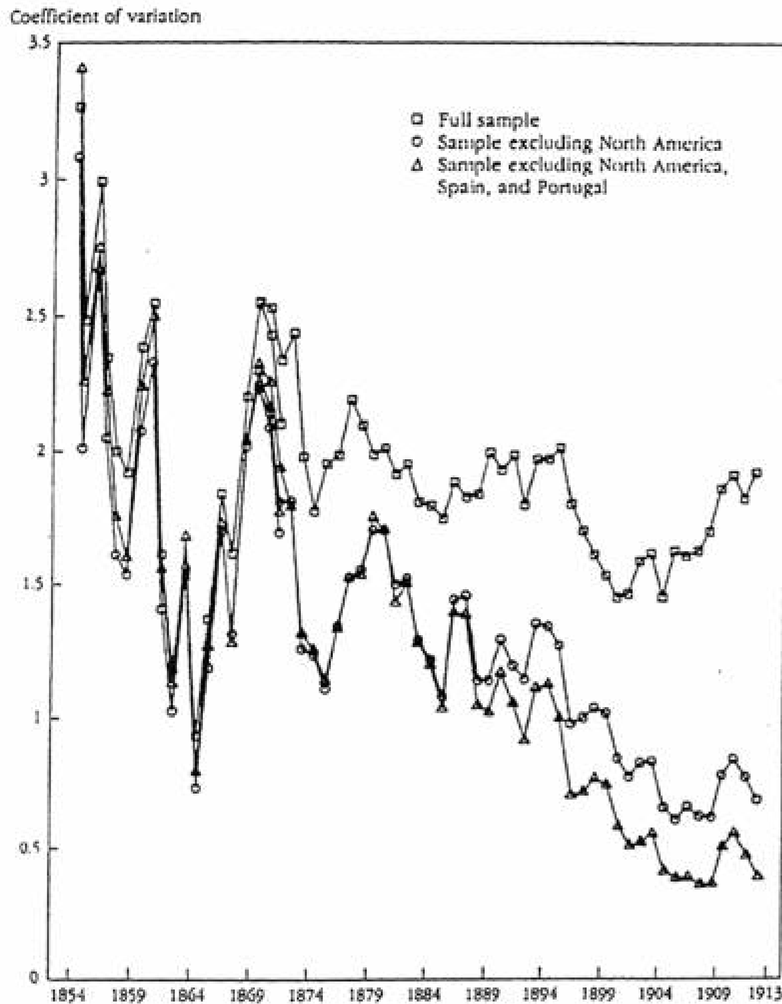

Figure IX.2. Real Wage Dispersion, 1854–1913. Note: Wage data are urban, male, adjusted for purchasing-power parity.
Source: Reprint of Figure 1, page 122 in Jeffrey Williamson, "Globalization and Inequality," *The World Bank Research Observer* 12, 2 (August 1997), 117–135.

In the years from 1913 until 1945, a period of protectionism and immigration quotas, the gap between rich and poor nations began to widen again. Because we are now entering another era of trade expansion and mass migration, Williamson's analysis raises the question, will the current era of globalization and growth bring about a similar convergence to that of the late 19th century?

Both Charles Jones (1997), and Paul Krugman and Anthony Venables (1995), argue that under certain conditions the answer to Williamson's question is yes. Assuming that the economic policies of the 1980s prevail, Jones predicts that world income distribution across countries is likely to be more compact in the future as a result of the general upward movement (Jones, 1997). Krugman and Venables come to similar conclusions by employing a complex model under what one may consider unrealistic assumptions. The authors predict a an inverted U

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shaped pattern of global economic change, with divergence in the short term followed by convergence in the long term (Krugman and Venables, 1995).

While the last one hundred and fifty years have been characterized by eras of lower and higher inequality, the dominant overall trend for the past century has been dramatic divergence. **Lant Pritchett**, who argues that the income of the richest 17 nations massively diverged from the incomes of all other nations during the period from 1870 to 1990. As Illustrated in Figure 9.3, Pritchett demonstrates that the ratio of income of the 17 richest nations to all other nations almost doubled rom 2.4 to 4.6 during that period.

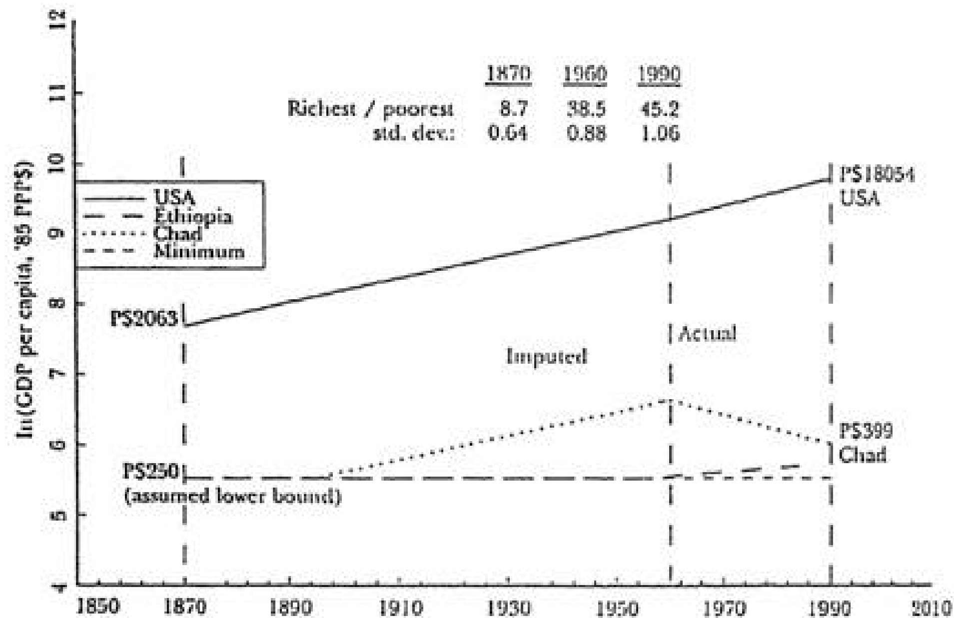

Figure IX.3. Simulation of Divergence of Per Capita GDP, 1870–1985 (showing only selected countries)

Source: Reprint of Figure 1, page 10 in Lant Pritchett, "Divergence, Big Time." *Journal of Economic Perspectives* 11, 3 (Summer 1997), 3–17.

In Pritchett's view, overcoming the disadvantages of being at the bottom is one of the most serious challenges to economics. This conclusion differs considerably from the business as usual approach that would follow from the analysis of Jones and others.

INCOME DISTRIBUTION WITHIN NATIONS

More recently, large income disparities have emerged within developed and developing economies as well. Similar to the above discussion, it has been argued that this may only be a short term phenomena; inequality might increase in the early stages of growth but decrease in the later stages. This relationship between distribution and growth has not held up empirically however. Moreover, the development policies pursued by those nations who were led to believe in this relationship have at times exacerbated existing inequalities.

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Kwan Kim discusses the different experiences of income distribution in developed and developing countries in recent decades. As discussed in in section 1 of this volume, inequality in the industrial democracies of Western Europe and North America have begun to widen since the 1970s. Inequality is on the rise in other countries as well. Here is a brief canvas of recent trends around the globe.

- In Central and Eastern Europe, inequality and poverty have risen during their period of economic restructuring -the situation being most severe in Russia and Bulgaria. Russia experienced a 0.14 - 0.24 rise in its Gini Coefficient from 1987-1993, and Bulgaria experienced a 0.11 increase.
- The Latin American economies are more unequal than other developing regions. Peru, Mexico, Venezuela, and Columbia all have Gini ratios above .50, and Brazil leads the list at .605.
- Sub-Saharan Africa remains the poorest region in the world, where the most grave concern remains the fundamental issue of human survival.
- Developing countries in the Asia Pacific region have on the whole, they done better in alleviating both relative and absolute inequalities. Malaysia, Indonesia, and Singapore stand out as nations which made progress in reducing inequality while China and Thailand did not.

Explanations for these variations are discussed later in this essay.

The picture is even worse for women. The 1995 UN Human Development Report (HDP) surveyed the condition of women across the globe. Problems of measurement and vast differences between countries (often driven by traditional cultural norms about appropriate roles for women) make cross-country comparisons difficult and render averages almost meaningless. However, common themes emerged from this UN undertaking: women lag behind men in both developed and developing countries along many economic and political dimensions.

A large majority of the world's poor are female, and the feminization of poverty is becoming worse. For many women, access to independent income through employment, land ownership, or credit is out of reach or falls short of self-sufficiency. In all countries reported on in the 1995 HDP, women's labor force participation rates and shares of earned income were less than men's. The UN cites a number of reasons for these disparities: women's concentration in low-skilled jobs; lack of bargaining power through unions; lack of access to maternity leave; and strongly held cultural norms that specify which jobs are suitable for women and/or discourage mixing men and women in the workplace. (UN, 1995).

INTERPRETATIONS OF THE KUZNETS CURVE

In a pioneering 1955 paper, Simon Kuznets hypothesized, on the basis of cross-sectional data, that inequality tends to increase in the early stages of economic growth and decrease in the later stages. For decades afterwards, development theorists vehemently advised policy-makers to ignore questions of inequality in the short term.

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Today, there is more extensive cross-sectional and time-series data available to test these idea. Empirical tests of these hypothesis establish that there is no consistent tendency in the inequality-development relationship.

A look at the time series data reveals that a good Kuznets Curve is hard to find as well (See Figure 9.4). In his look at this data, Fields concludes that “there is no empirical tendency whatsoever in the inequality development relationship.” In his sample, inequality increased in half the countries growth experiences and decreased in the other half. This result held when looking at fast-growing developing economies as well. Inequality rose with the same frequency in the fast-growing developing economies as in the slow-growing ones.

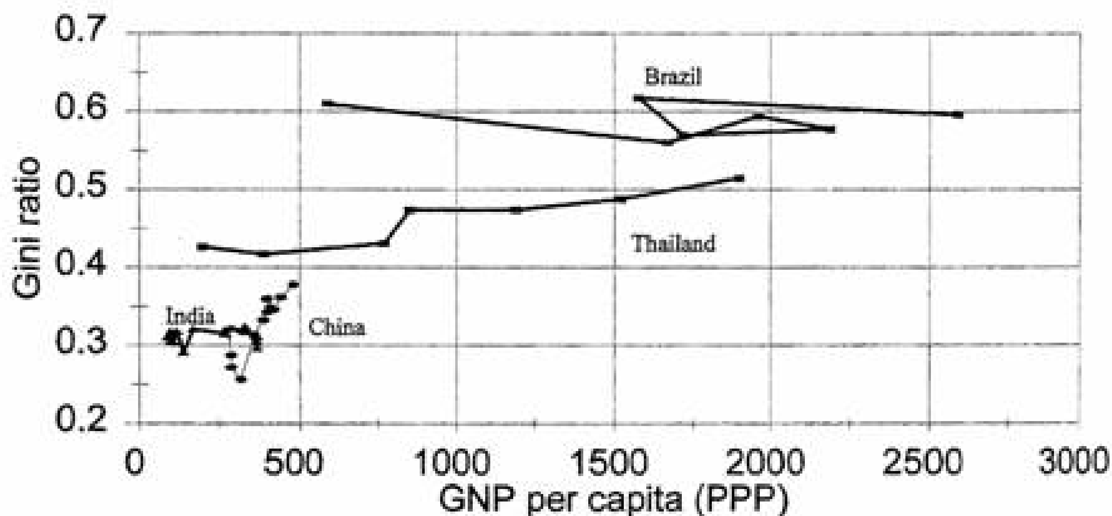

Figure IX.4. A Good Kuznets Curve Is Hard to Find
Source: The World Bank, *World Development Indicators*, 1998.

Irma Adelman and Nobuhiko Fuwa assert that the share of the poorest quintiles follows a path shaped more like a Nike “swoosh” than a U. Looking at all the less developed countries for which income distribution data could be found, 45 countries for the 1970s and 38 countries for the 1980s, they found that, on average, very little movement toward equality accompanies the process of growth. This is the case in all but the richest quintile; for the top group, the U is inverted. However, the right-hand side of the U is extraordinarily flat. The share of the poorest quintiles drops rapidly, at very low levels, and then rises very slowly thereafter. This becomes vivid in Adelman and Fuwa’s graph reproduced in Figure 9.5.

The share of the poorest quintiles drops rapidly, at very low levels, and rises very slowly thereafter. The poorest quintile does not recover the income share it had at a per capita income of $100 until the country reaches the income level of a developed nation. The flatness of these curves shows that the poorest, for all practical purposes, stay that way.

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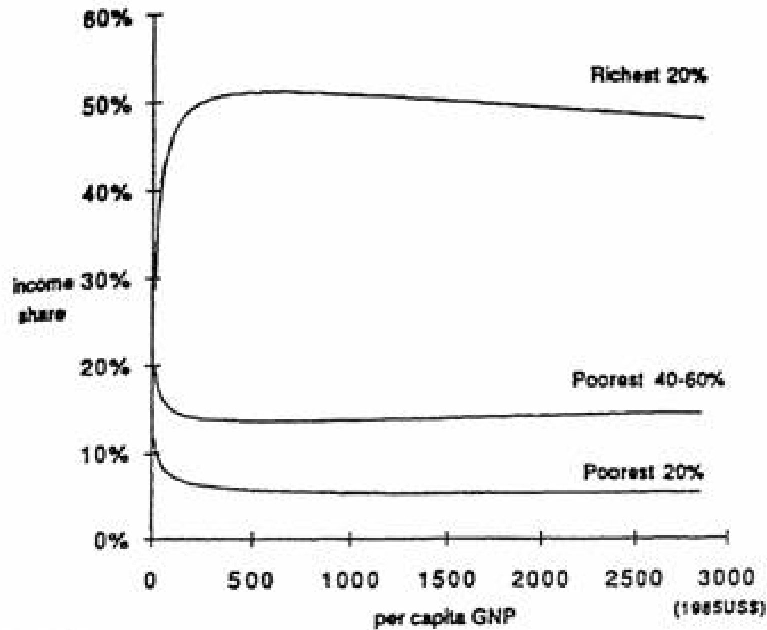

Figure IX.5. Estimated Kuznets Curve, 1980s
Source: Reprint of Figure 2, page 21 in Irma Adelman and Nobuhiko Fuma, "Income Inequality and Development: The 1970s and 1980s Compared." *Economie Appliqué* XLVI (January 1994), 7–29.

Although the empirical evidence to support the Kuznets curve has faded, a parallel idea has come to life in another literature. A 1995 paper by Gene Grossman and Alan Krueger found, for a number of environmental variables, that the relationship between per capita income and environmental degradation is an inverted U form (Grossman and Krueger, 1995). In simpler terms, environmental quality first worsens but then improves with rising income. Unfortunately, the same misguided policy prescriptions that came with the original Kuznets argument are being advocated in the environmental arena -grow now, clean up the environment later (to be addressed at length in the next Frontiers volume, *Sustainable Human and Economic Development*). This body of work has become known as the Environmental Kuznets Curve (EKC) literature. Like the debates over the original Kuznets work, the EKC is under empirical and policy attack.

An article by Mariano Torres and James Boyce in the EKC literature is of particular relevance to this volume. They look at the relationship between income, inequality, power, and levels of pollution (Torras and Boyce, 1998). What is unique about the Torres and Boyce approach is that they attempt to see if inequality and the level of power in a nation are the key links between pollution and per capita income. Their theoretical inspiration for this approach comes from non other than Kuznets himself. They refer to Kuznet's "unsung" hypothesis as the base of their analysis:

> "One may argue that not only the welfare equivalents but also the power equivalents of the same relative income spread show a much wider range when the underlying average income is low than when it is high." (Kuznets, 1963, 49)

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The authors plausibly hypothesize that greater inequality of power will be associated with higher levels of pollution. Those who benefit from pollution will be better able to prevail against those who bear the costs of pollution. The devil here however, is in the details. To test for power inequality the authors include the literacy rate, Gini ratios, and a set of measures reported to represent political rights and civil liberties. The latter set of variables are what makes their analysis problematic. Based on a ranking system deployed by an organization called Freedom House, the authors create a 0-12 scale that has higher values representing greater freedom. This is a prime example of the oversimplification of political science that Atkinson refers to in Part I of this volume -creating an arbitrary and obscure quantitative summation of characteristics of complex societies for the sole purposes of quantitative analysis. A critique of such methodologies is discussed later in this essay. This being said, the Torras and Boyce article is a pioneering first attempt to introduce power and inequality into the EKC debates.

THE CONSEQUENCES OF THE GROWTH FIRST PARADIGM

Relying on the early appearance of supporting evidence for the Kuznets curve, development economists sternly advised developing nations to grow first and worry about inequality later. A consensus emerged that growth could best be attained in developing countries by making the following "adjustments": liberalizing trade, privatization, public sector reforms, and currency devaluation. In many cases, these policies took the form of formal structural adjustment programs administered by the World Bank and the International Monetary Fund.

Trade liberalization has been the pillar of the "growth first" agenda. The last Frontiers volume, *The Changing Nature of Work*, discussed opposing views on the effects of trade liberalization on inequality in the developed nations.

George Borjas, looking at the United States, bolsters the minority view by arguing that trade is a major cause of wage inequality. He demonstrates empirically that the trend in wage inequality parallels the U.S. trade deficit in durable goods, and suggests that in theoretical terms, import competition would be expected to have a particularly strong effect on wages in concentrated industries, such as durable manufacturing. He shows that evidence on wage trends in selected industries lends support to the theory.

The "growth first" paradigm also has problematic implications for developing countries. Economic theory suggests that greater openness to world trade in developing countries would reduce wage inequality because liberalization raises the relative demand for unskilled workers and therefore reduces the wage gap between the skilled and the unskilled. In some cases this has been the case, in others it has not. **Adrian Wood** shows that the evidence from East Asia during the 1960s and 1970s supports the theory but the Latin American experience since the mid-1980s has not. During periods of trade liberalization in Latin America, skill differentials in wages widened. Many of these changes are attributed to changes in labor market institutions in those countries and to overall changes in the world economy -specifically the entry of large low income Asian countries into world markets. Earlier, when the East Asian "tigers" entered the world market they were relatively low-wage producers, with a comparative advantage in labor-

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intensive manufacturing. But by the 1980s, Latin American countries were middle-income range, in the and their unskilled workers in labor-intensive export industries could not compete with their East Asian counterparts.

Another pillar of growth first schemes has been privatization. Since the late 1980s, privatization efforts have surged in the developing countries. During this period, revenues increased from $2.6 billion in 1988 to $23.1 billion in 1992. Privatization occurred most in Latin America and the Caribbean -accounting for 70 percent of all of the privatization in the developing world. Infrastructure was the leading sector for privatization, and the second most important was industrial production.

Who have been the purchasers of privatized enterprises? Increasingly the answer is foreign investors. From 1988-1992, privatizations accounted for close to 10 percent of all foreign direct investment flows to the developing world. This trend presents developing country governments with a distributional dilemma. The developing countries desperately need funds from their privatization schemes, but they also want some deal of control over who receives the benefits. However, the exertion of control over the process may scare away foreign investors.

Balance of payments shortages and other macroeconomic disequilibria make it hard to turn away foreign investors. At the same time, the World Bank and related institutions have actively encouraged privatization in developing countries. Close to 70 percent of all structural adjustment loans and 40 percent of sectoral adjustment loans during the 1980s had a privatization component.

Paul Cook and Colin Kirkpatrick argue against the tendency of economists to evaluate privatization programs on efficiency grounds alone, and leave distributional concerns to political scientists. This approach, in their view, is one of the primary reasons why so many economists can not adequately explain the development process. Cook and Kirkpatrick develop a political economy approach to examine the distributional impact of privatization in developing countries. Their analysis reveals that privatization has occurred to promote specific groups' economic interests, rather than the advancement of welfare in the entire nation. Privatization usually benefitted the same interests and groups that were favored before the schemes were utilized.

Adelman and Fuwa show that for the1980s, structural adjustment policies appeared to have become the more important influence causing inequality in developing countries. While this is the overall case, structural adjustment seems to have had varying degrees of success and failure worldwide. There is an enormous literature that consists of case studies of structural adjustment programs on specific countries, but they all seem to have a similar and relatively unsatisfying conclusion -the effects of adjustment are varied, complex, and locally specific (see for example, Bourguignon et al, 1991).

Nevertheless, structural adjustment policies are said to affect individuals and households in developing countries in three ways: changes in employment and income, changes in the price of goods and services, and changes in the provision of public services. One survey suggests that the groups that are least linked to the market, the rural poor and informal sectors in urban cities,

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are the least exposed to price changes. The formal sectors in cities are seen to be the hardest hit because they are exposed to changes in consumer prices (Nelson, 1992).

There is an emerging consensus that the equity effects of structural adjustment in Africa have been largely negative. In 1995 the Ministry of Foreign Affairs in Denmark published a comprehensive study of the effects of structural adjustment in five African countries: Burkino Faso, Ghana, Tanzania, Uganda, and Zimbabwe. The report shows that rural areas in these countries experienced an increased differentiation as a result of adjustment induced changes in agricultural pricing and marketing. Conversely, (and contrasting the broad conclusions of researchers such as Nelson) urban areas seemed to benefit from the increase in aid flows and imported goods. The developments in the urban areas brought about a surge in the construction sector and in the demand for informally provided services. The two trends taken together imply that the rural/urban wage gap greatly increased during the course of adjustment in these African countries.

Concluding an assessment of the developing experience during the the heyday of structural adjustent policies, noted development economist Lance Taylor concludes " there is no single answer to the fundamental question of why nations grow at different rates, with diverse distributions of income and wealth. It is clear that policy must be tailored to the local situation and even to the particular conditions prevailing at the time." (Taylor, 1995, 262) He goes on to show how sharply this view contrasts with the "Washington Consensus" about how a relatively uniform policy package can be applied to developing countries with beneficial results almost everywhere .

LEARNING WITHOUT CURVES

If the Kuznets curve estimates and actual development experiences show us that growth only policies do not ensure equality, what does? An alternative literature of both empirical slowly emerging that challenges the studies that support and advocate the growth first agenda outlined above. An empirical literature arguing that unequal societies tend to have weaker economic performance than egalitarian societies is beginning to break into the more mainstream economic journals. While intuition and idealism would cause many, including the editors of this volume, to applaud the intent such studies, a look at their methodology reveals that this literature is still in its infancy.

Alberto Alesina and co-authors looked at 71 countries during the period 1960-1985. They argue that the evidence in these studies implies that the more egalitarianism from the onset is correlated with a positive growth path. Their theory however, based on the "median voter" theorem: the tax rate or other economic policy selected by the government is the one preferred by the median voter. That theorem is relevant because the more equitable the income distribution, the better endowed is the median voter with capital -and hence the more reluctant is the median voter to favor taxation of capital. It is also assumed that, the lower the level of capital taxation, the more the economy will grow. A related argument is that inequality will fuel political instability and reduce investment, and therefore reduce growth. As a result, inequality and investment should be inversely related (Alesina and Rodrik, 1994, Alesina and Perotti, 1996, Persson and Tabellini).

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While these studies seem consistent with intuition, if somewhat constricted in their view view of both politics and economics, they have been shown to have serious methodological flaws. Because the authors rely heavily on cross-sectional analyses using the median voter theorem, the designation of what is a democracy is a crucial part of the analysis. One study listed South Korea (in the 1960s and 1970s), El Salvador and Panama as democracies! In an article that makes a number of other important critiques of the data and methodology in these studies, another author wrote "coding South Korea as a democracy in the 1960-1985 period is fairly outrageous: grabbing power by military coup and persecuting opposition leaders is simply incompatible with elementary democratic procedures." (Weede, 1997). A.B Atkinson, in an article summarized in Part 1 has added "In my view, this understates what economists can usefully learn from political scientists... The median voter theory is far from being "standard.'" (Atkinson, 1997).

Like the article by Adrian Wood discussed above, **Gary Fields** points to the successes of the East Asian countries to show how an equality- first approach can work. Inspired by the work of philosopher John Rawls, Fields hopes that development would focus on maximizing the wellbeing of the worst-off person. Thus, an approach of broad-based growth, i.e., growth that is targeted on raising the living standards of the poor, but also raises the living standards of all socioeconomic levels, is most effective.

Based on the success of the East Asian nations, Fields provides a list of the following parameters that can help nations achieve broad-based growth:

- Policy makers have to strike a balance between not raising the returns to labor prematurely (if wages are excessive, employment and output could be reduced) and not repressing wages permanently (which would exclude the poor from the benefits of growth). Because labor is so abundant in the developing world, labor intensive growth can be more beneficial for the poor than capital intensive growth.
- Just as important as the quantity of labor demanded is the quality, or skills that workers bring to the labor market. There may be no tradeoff between equity and efficiency when it comes to education. Spending additional educational dollars on primary education rather than higher education may add more to the productive capacity of workers and spread the benefits of growth in a more broad based manner.
- As with resource allocation for education, there may not be an equity-efficiency trade off when it comes to land. In the early post World War II period there were significant land reforms in many of the East Asian countries, laying a relatively egalitarian foundation. There are three advantages to having such an initially egalitarian distribution. First, the asset of land generates income and hence spreads the benefits of growth to the poor. Second, since it is well known that small farms have higher yields per acre, a more equal distribution of land would raise total agricultural productivity. Finally, those with land hold a great deal of political power. Keeping power out of the hands of a landed oligarchy can be beneficial to the poor.
- Key to a successful development approach is sound trade and industrialization strategies.

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The East Asian economies were able to maintain full employment and rapidly rising real wages. Much of this is attributed to export-led growth. These nations chose their trade policies carefully, adapting their policies as their comparative advantage shifted more to lower-wage countries, as they moved into higher-wage sectors.

SUMMARY

The articles included in this section, and the other literature cited here, cover a lot of ground. An enormous amount of theoretical, econometric, and case study work has aimed at documenting and understanding the extent of inequality and poverty around the world. To summarize the major themes in this essay:

- Income distribution across nations has remained dramatically unequal since the late 1980s.
- Over the past two hundred years the overall trend has been a divergence of income across nations, but during that time their have been relatively more equal periods than others, particularly from 1854-1913.
- The Kuznets hypothesis, that inequality tends to increase in the early stages of economic growth and decrease in the later stages, no longer holds up to empirical and theoretical tests.
- The ‘growth first” development policies of recent decades, including trade liberalization, privatization, and structural adjustment have had varied results on income distribution within nations. Standing in stark contrast are the East Asian and Latin American experiences.
- “Broad Based Growth,” growth that is targeted on raising the living standards of the poor, but also raises the living standards of all socioeconomic levels, can be most effective.

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