# A Turning Point in Global Inequality … and Beyond

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## 1 Introduction

We are at a turning point in history. A secular trend of increasing inequality is being reversed. Inequality in the world has continuously increased for a century and a half since the beginning of the Industrial Revolution. It is now decreasing at the same time as global growth is accelerating. A historical reversal is taking place in the global economy. Many countries in the South, including large emerging countries such as China and India, appear to be on the same path of growth as today's richest countries.

This transition raises several important questions. Is this trend of decreasing global inequality sustainable? Will it continue at the same pace as global growth, or will global growth decelerate? Seeing as inequality seems to be increasing in a number of countries, could it be the case that domestic inequality will replace international inequality to some extent? If the rise of domestic inequalities were to be somehow associated with globalization in the public opinion, could it be a threat to the process of global development as a whole?

## 2 A Turning Point in Global Inequality?

### *Data and Measurement*

To show the reversal of the historical trend for the period of 1989 to 2006, I am using purchasing power-corrected GDP per capita figures from national accounts. For distribution I am also using data from the OECD for OECD countries, and from the POVCAL database for developing countries. The analysis of this period is based on a group of 160 countries.[1] For the historical period I am using the results obtained by Bourguignon and Morrison (2002) based on the historical GDP series collected by Maddison[2] and adjusted for purchasing power parity and on original distribution data.

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[1] For a very limited number of countries there is no data on the within-country distribution of income. In this case we approximate and use the distributional data of a similar country.

[2] A. Maddison, The World Economy : A Millennial Perspective, OECD Development Centre, 2001

*Results*

Figure 1 shows the results. The figure represents the changes in inequality using two different indicators of inequality. The blue graph on the left axis is the GINI coefficient, a summary measure of inequality ranging from zero (no inequality) to one (maximum inequality). The red graph represents another measure of inequality: the relative income of the top twenty percent of the richest people of the global distribution over the income of the twenty percent of the poorest people. It is important to keep in mind that both 'quintiles' include people from both rich and poor countries.

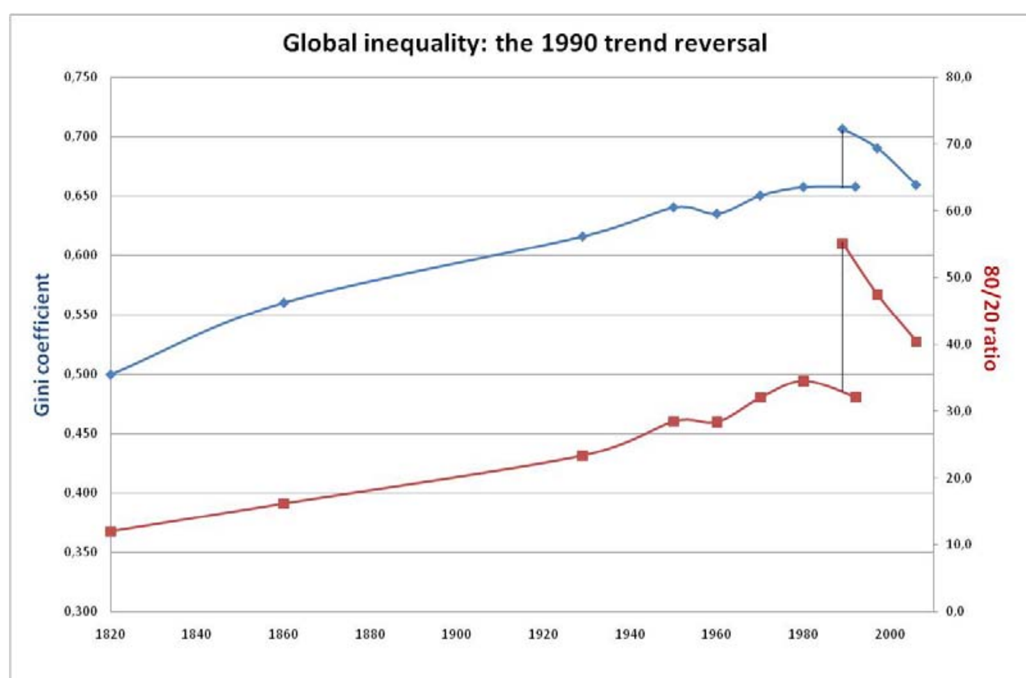


Figure 1: Global Inequality. Source: Bourguignon and Morrison (2002) and own calculations.

There is a sudden surge in the graphs at 1989 because the calculation for the period from 1820 to 1989 is not comparable to that for the more recent period. The former was based on a smaller number of countries or groups of countries. One reason for this is that many countries simply did not exist during most of that period. A second reason for the surge in the graphs is a change in the purchasing power parity. For the period from 1820 to 1989 the purchasing power parity used by Maddison is based on the year 1990, whereas for the period from 1989 to 2006 we are using purchasing power parity based on 2005 data. Changing the purchasing power parity basis yields highly significant differences in purchasing power-

adjusted income. In particular, poor countries are actually poorer when using 2005 as a basis than they are when using the 1990 basis.

The dramatic feature of Figure 1 is the increase in inequality over the nineteenth century and the first two thirds of the twentieth century, until around the 1970s and 1980s, at which point we see a flattening of the blue graph and even a small decrease in the red graph. In the period from 1989 to 2006, however, the trend is completely reversed. Inequality decreases, and it decreases at a very fast pace.

Figure 2 shows the reasons for this change in inequality, with the annual growth rate for GDP per capita for developing countries in blue and high-income countries in red. This figure shows what could be called a 'decoupling' of growth trends. There has been much discussion recently as to whether we are now living in a world where the economic cycles of the North and the South might be 'decoupling.' However, Figure 2 shows that even when including the recent crisis, this is certainly not the case. The same fluctuations clearly affect growth in the two sets of countries. What is remarkable, however, is that from the early 1990s onwards there is a divergence in growth trends between developing countries and high-income countries. The factor that best explains the decrease in global inequality in recent years is this divergence in growth rates, as a result of which developing countries are growing much faster than high-income countries. This is true even during the late-2000s global recession. The difference in terms of growth rates between the North and the South remained basically the same when compared to periods during which the global economy was peaking. So, there seems to have been a growth rate gap between the North and the South over the last 10 years or so, the width of which has not changed significantly in the last 5 years. If this trend continues, it certainly is an important novelty in the history of global economy.

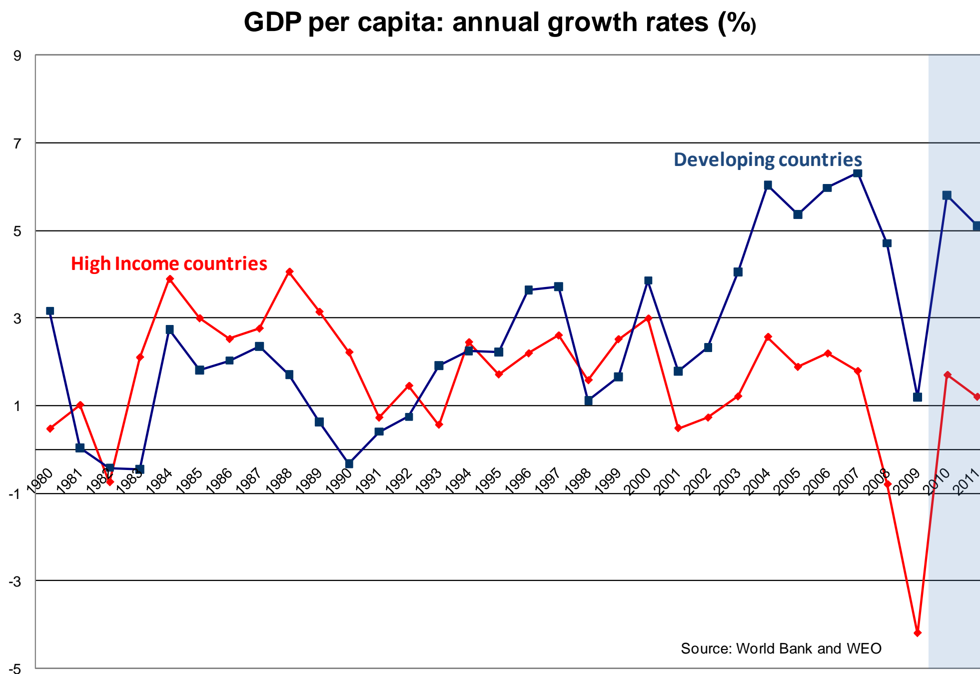


Figure 2: GDP per capita annual growth rates

*Caveats*

The above results must be interpreted with some caution for several reasons. It is important to distinguish between a 'between inequality' (the inequality that would result only from the difference in mean income between countries) and a 'within inequality' (the inequality that results from income differences within countries). Figure 3 shows the decomposition of global inequality into between and within inequality using the Theil index, an inequality statistic that is easily decomposable into these two components. The pink graph shows the development of global inequality. It is very similar to what we see in Figure 1, with the same discontinuity and the same trend reversal. The blue graph shows the inequality between countries. In other words, it ignores inequality within countries by assuming that within each country all people have the same income. The shape of the blue graph is very similar to that of the pink graph: a large increase in inequality for a very long time and then a drop in inequality over the last 20 years. The green graph corresponds to the average inequality within countries. It measures the degree of inequality that would be observed if all incomes in a given country were scaled up or down so that the national mean income would be equal to the global mean. The graph shows that in the recent past there has been a slight increase in within-country inequality.

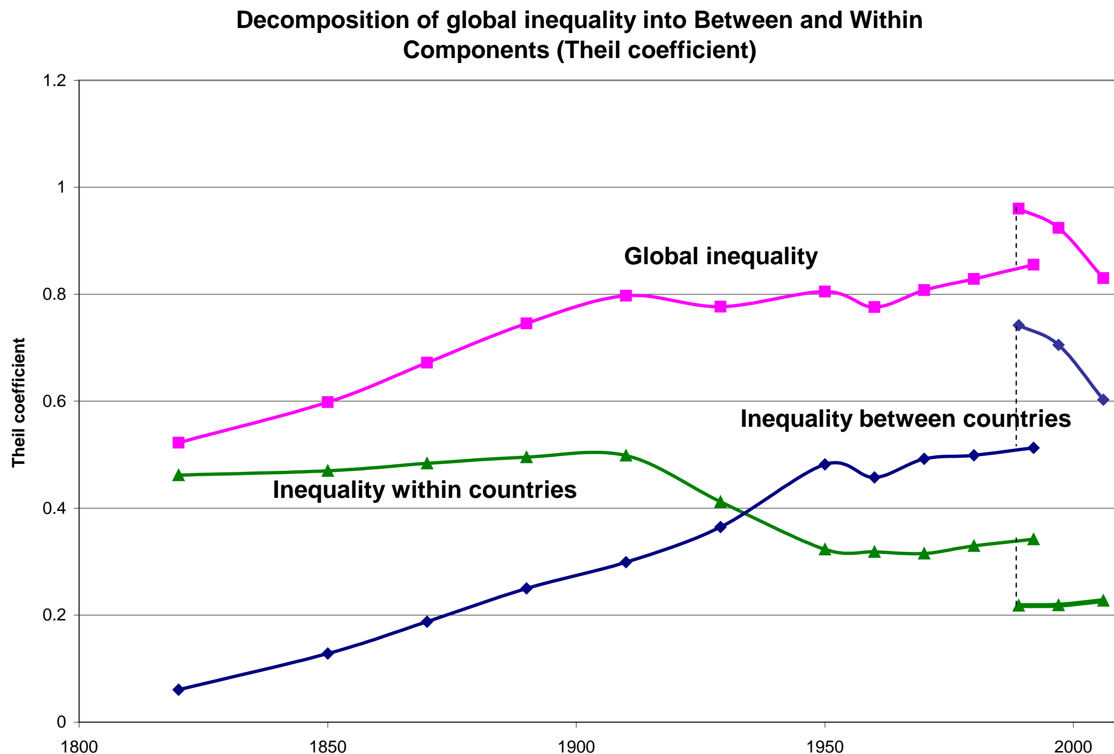


Figure 3: Decomposition of global inequality Source: Bourguignon and Morrison (2002) and own calculations.

It must be stressed that the view that global inequality is now decreasing is challenged by some scholars. Actually, those who hold that view implicitly may be using a different concept of inequality. Figure 3 illustrates this point by showing the development of 'inter-country inequality'. This concept corresponds to the case which uses as the statistical unit the country rather than every one of its citizens. In other words, countries are no longer rated by their population, with the result that China, for example, is given the same weight as Luxemburg. Inequality measured in this way is represented by the blue graph, whereas the red graph shows the level of global inequality as it was measured before. Both graphs show the ratio between the mean income of the tenth decile and that of the first decile. Without the influence of population, the blue graph thus shows the ratio between the mean income of the 16 richest countries in the world and that of the 16 poorest. With this concept, global (or inter-country) inequality continued to increase during the period from 1989 to 2006.

Proponents of the view that, based on this kind of evidence, inequality in the world has continued to increase in the recent past are not completely wrong. They are simply using an inequality measure that is somewhat extreme in the sense that what matters in measuring inequality is the relative level of welfare of the poorest individuals in the world compared to

the richest, irrespectively of how many they are. In other words, the fact that a few hundred millions of people have escaped poverty in China, India, Bangladesh and other large countries cannot compensate the fact that 3 millions of Burundians have on average become slightly poorer. [3]

It should also be emphasized that the above results may vary depending on the type of data source. National account data are used here to calculate the mean income per capita in a country, while household surveys are used to estimate the relative incomes of the various deciles with respect to that mean income. It would also be possible to just use household surveys instead. Indeed, at one point in time there is a difference between the global inequality estimates obtained from these two sources. Recent inequality trends are not necessarily the same either.[4] In the long run, however, it is very difficult to imagine that growth rates will not be more or less comparable across the two sources.

*Is the decrease in global inequality accompanied by a decrease in global poverty?*

Figure 4 shows the development of poverty rates in developing countries over the past 30 years. Obviously, global poverty has been decreasing. Between 1980 and 2005 poverty was cut by half. If this trend continues until 2015, the Millennium Development Goals will most likely be achieved worldwide.

[3] Such a concept of inequality is described in the literature as 'Rawlsian', following the principles of justice proposed by Rawls (1971)

[4] See Milanović (2009)

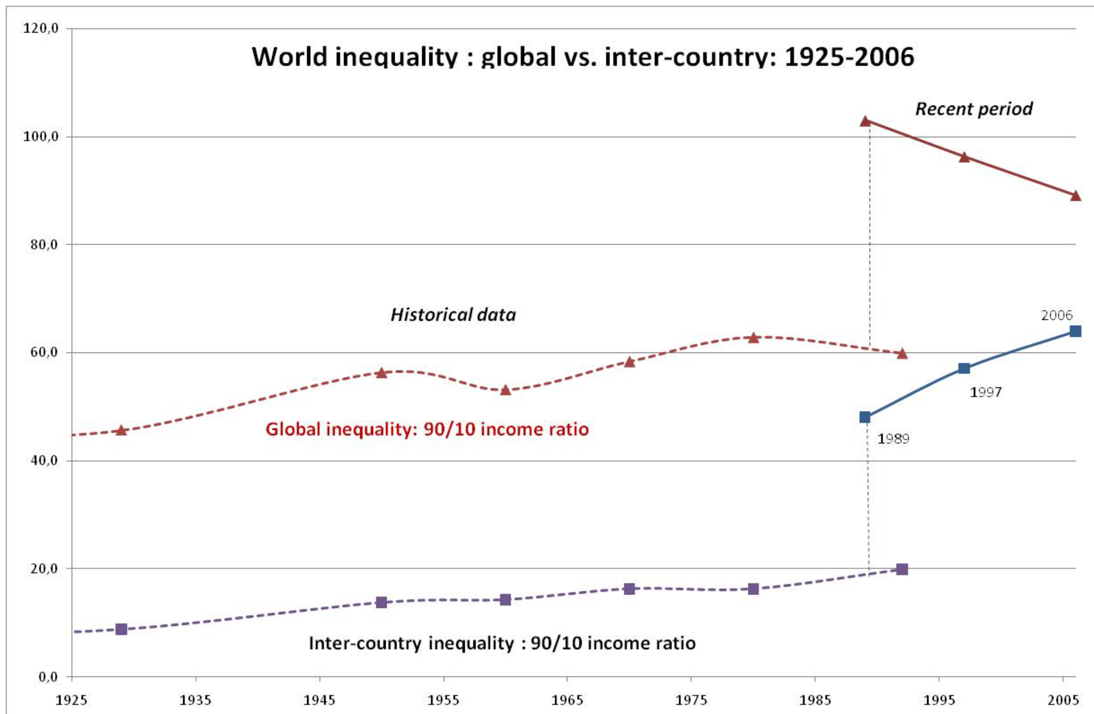


Figure 3 : Global vs. Inter-country Inequality 1925–2006 Source: Bourguignon and Morrison (2002) and own calculations.

**3. Medium-Term Perspectives and Issues**

What is the economic outlook for the next ten years? Although it is always risky to make long-term forecasts, there are many reasons to believe that growth rates in developed countries will be limited. There are several reasons for this. First, it will be a long time before the problem of national debts is completely solved. Second, many countries are probably at the beginning of a period of fiscal contraction. Third, we know that there is a huge unemployment hysteresis which will continue to affect those economies and their consumption power for quite some time. While these three reasons are short-term and essentially cyclical, there are also long-term (or structural) causes for slow growth rates. A new wave of financial sector regulations is only starting. One of them, Basel III, will be at the top of the agenda in the next meeting of the G-20. Also, many countries of the North are in a strong and harsh process of structural adjustment. For example, manufacturing employment in the United States has been reduced by approximately five percentage points as a proportion of the total labor force over the last ten years. This implies that half a  percent of the workers in manufacturing  have to relocate t to another sector every year, which necessarily causes

considerable friction. This phenomenon has been observed not only in the United States but also in many parts of Europe.

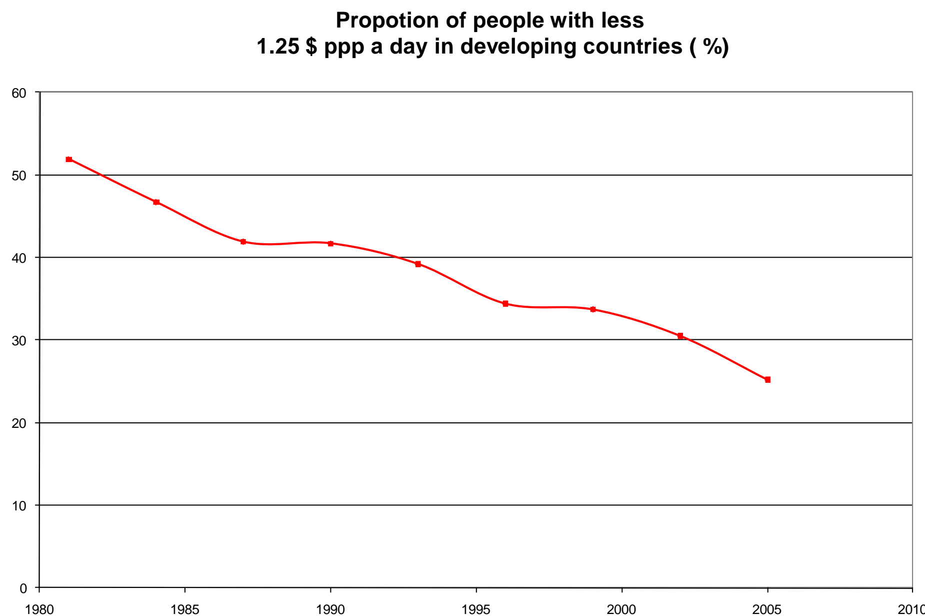


Figure 4 : Proportion of people living in extreme poverty (Source: PovcalNet)[5]

In large emerging countries, on the other hand, growth is likely to continue at a fast pace. Although exports to rich countries may slow down, these countries can rely not only on very large domestic markets, but also, increasingly, on the quickly developing South–South trade. However, to continue to grow at a very fast pace, some countries, such as China, may have to change their development strategy.

China will find it necessary to shift its development strategy from foreign markets to domestic markets. Not only will the demand for exports to the North decrease but the global market share of such a large country is limited as well. To continue to grow at about twice the mean global growth rate, China will have to shift the focus to its domestic markets. This objective is explicitly mentioned in the five-year plan recently adopted by its government. The question is how to implement it.

Even though fast growth is likely to continue in large emerging countries, it will probably be at a slightly slower pace than before because of sluggish growth in the North. We

[5] The PovcalNet Online Poverty Analysis Tool is a World Bank web application which "provides distributional data and a user-defined poverty line/PPP to estimate the poverty and inequality measurements for a selected country or group of countries" (PovcalNet, 2011).

should not forget that countries in the North still represent 55 to 72 percent of global GDP, depending on whether GDP is measured in terms of purchasing power parity or in U.S. dollars. Consequently, the slow down in those countries necessarily affects the rest o fthe world.

Even so, the trend of decreasing global inequality due to the rebalancing of the North and the South in the global economy is most likely to continue. The decrease in global inequality over the last 20 years is not cyclical; rather, it reflects a very strong structural trend in the global economy.

Still, I would like to emphasize two important caveats.

*Caveat 1: Growth in Sub-Saharan Africa*

The first caveat concerns Sub-Saharan African countries. Clearly, it may not be appropriate to draw too close an analogy between economic growth in large emerging countries such as Brazil, China, and India and growth in Sub-Saharan Africa. The green graph in Figure 5 shows the annual GDP per capita growth rates in Sub-Saharan Africa. A dramatic change occurred in the early 2000s, when growth rates increased significantly, even exceeding those in high-income countries. Before this change there was a long period during which the growth rates of Sub-Saharan African countries were markedly lower than those in both rich countries and other developing countries in the world.

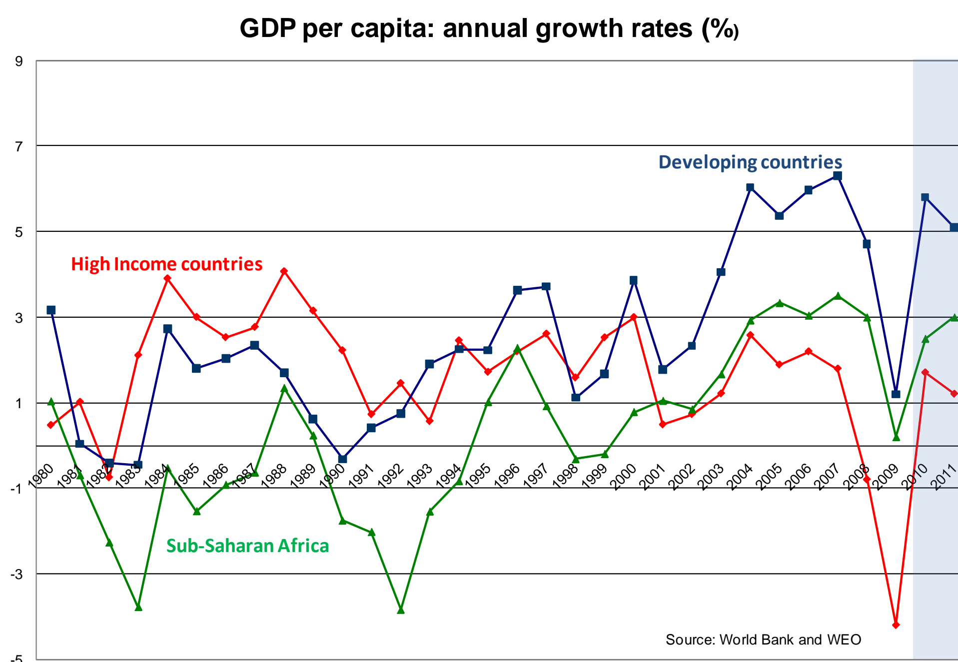

Figure 5 : GDP per capita : annual growth rates

The important and interesting question is whether this recent trend reversal in Sub-Saharan Africa is truly structural or just cyclical in nature. Some argue that the recent fast growth in Sub-Saharan Africa is the result of improved governance and is therefore structural. If there is little doubt that policies in Sub-Saharan Africa have improved, particularly in macroeconomic policies, the question is whether this is sufficient to guarantee that long-term growth will follow. Others argue that the recent fast growth in Sub-Saharan African countries is due to high commodity prices. The day those prices go down, growth rates in Sub-Saharan Africa will fall as well.

Which is most likely to explain the recent growth performances in Sub-Saharan Africa: improved governance or high commodity prices? A good reason to support the second view is the lack of significant changes in the structure of African economies. For the region as a whole, and even when abstracting from South Africa, it turns out that the manufacturing sector remained constant over time, at ten percent of GDP, even in non-oil producing countries. It is true that the GDP share of agriculture is going down, but it is essentially made up for by a growing service industry. Services typically respond more to demand stimuli than to changes in production capacity. As long as there is no sign of a change in the structure of GDP in Sub-Saharan African countries, particularly in the production of goods rather than services, it is difficult to think that an autonomous growth process is taking place in those countries. The hypothesis that links recent growth trends in Sub-Saharan Africa to high commodity prices cannot yet be discarded and we should not be too optimistic about the sustainability of recent growth in this region.

Due to fast growth of emerging countries, demand for commodities will remain strong. Would that not imply that commodity prices will remain rather high? This is far from certain. Growth in developed countries will continue at a slower rate, with weakening effects on global commodity demand, but a supply response to presently high commodity prices may also be expected. In other words, commodity prices may not remain at the present high level for long, and if they do not, sub-Saharan development would require greater economic diversification.

Why could Sub-Saharan African countries not live off the rent they receive for their natural resources, like the Gulf countries do? The big difference between countries of the Gulf Region and Sub-Saharan African countries lies in their demographic structure. It is very difficult to imagine that a population approaching one billion could live and develop on such

rents alone. The diversification of economic activity in Sub-Saharan Africa is a necessary condition for sustainable growth. A particularly important step is diversification into a manufacturing sector that trades at regional level and/or with the rest of the world.

There is clearly a need for an actual regional integration in Sub-Saharan Africa to develop larger local markets. The combination of larger markets and population growth makes diversification possible, despite an initial comparative advantage in natural resources. Indonesia, for example, has shown that even countries with large natural resource endowments can achieve diversification of economic activities. Over the last 20 years the country has been able to develop a dynamic manufacturing sector, despite its rich oil reserves. In other words, there is no fundamental contradiction between natural resource wealth and a growing manufacturing sector. One major issue is the current small market size of all Sub-Saharan African countries except South Africa. Indonesia has a population of 250 million. There is no market of such magnitude in Africa. Regional integration should permit this problem to be rectified to create the basis for economic diversification and, thus, sustainable growth.

We have to keep in mind that poverty in the world will become more and more an African problem if current trends continue. If we really care about global inclusion and equity, we must concern ourselves with what is happening in Africa, particularly with the available instruments for global redistribution. These instruments are not limited to foreign aid, but also include trade policies—in particular, trade preferences by countries of the North with respect to Sub-Saharan Africa.

*Caveat 2: Within-country inequality*

The second caveat concerns inequality within countries. Aside from a decrease in global inequality over the last 20 years, there is also a noticeable increase in inequality within a number of countries. Figure 6 shows the substantial increases in inequality in four of the G-7 countries—Germany, Italy, the UK, and the U.S.—over the last 20 years. In effect, inequality has increased in almost three quarters of the OECD countries over that period. France is among the few countries with almost no change in inequality. The inequality increases in other countries are often linked to a change in redistribution policies, but also to changes in the distribution of market incomes.

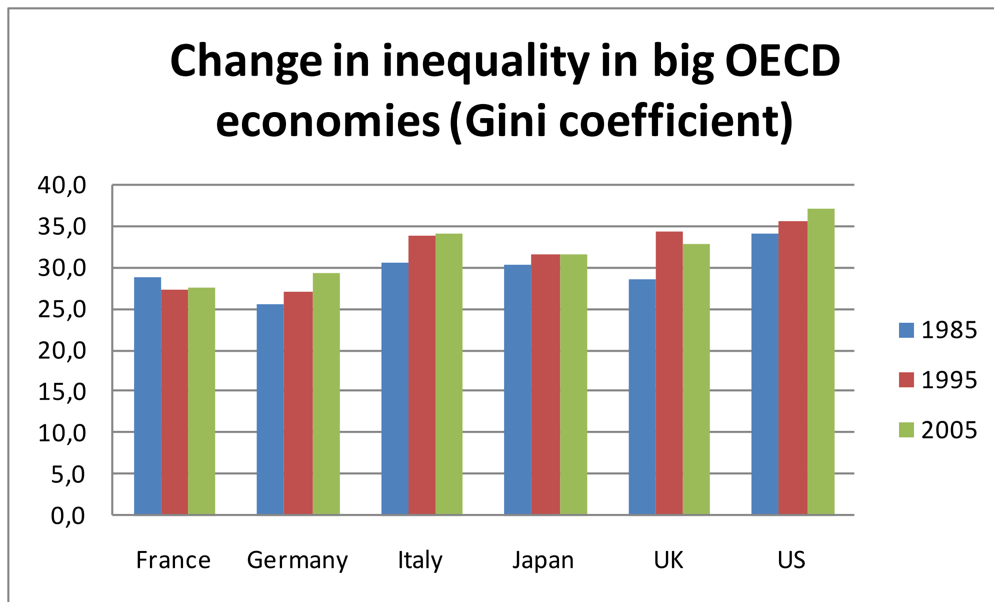


Figure 6: Change in inequality in **major** OECD countries (Source: OECD, 2009)

Figure 8 shows income distribution figures for the United States (after tax and transfers).[6] Between 1979 and 2004 the total income increase of the poorest 20 percent was six percent. The income of the richest 20 percent, however, grew by 70 percent over the same period, while the mean income of the richest percentile grew by 176 percent. Even though some feel that these figures may be unrealistically high, there is little doubt that inequality in the U.S. economy has surged in recent years.

In Europe the increase in inequality is less, but at the very top of the income distribution (executives, traders, etc.) salaries paid in France, Germany, and the UK are approaching parity with income levels in the U.S. There is a growing sense of inequality due to the disparity between very high incomes at the top of the income distribution and low or even median incomes, and also due to high unemployment in some countries. Despite the benefits global growth may provide to the global community, including developed countries, such perception of a growing inequality may also lead to a backlash against globalization, for instance through a push towards protectionism.

The trend of rising within-country inequality is observed not only in OECD countries, but also in various developing countries. As many as 60 percent of the developing countries for which data are available show an increase in within-country inequality over the last 20 years or so. The country with the most dramatic increase is China, but an examination of the

[6] Figures are from an official report to the U.S. Congress.

implications of such a development should also take into account the country's socialist past. There are also signs that inequality is increasing in India.

It is remarkable that, despite rising within-country inequality, global inequality is decreasing at a fast pace. The problem, however, is that what is happening at the national level may be more important from a political economy point of view than what is happening at the global level. An increase in inequality at the national level may become a real obstacle to global inclusion and global development even though global inequality is decreasing.

**Figure 7 : Average After-Tax Income by Income Group**

| Average After-Tax Income by Income Group (in 2004 dollars) | | | | |
|---|---|---|---|---|
| Income Category | 1979 | 2004 | Percent Change 1979-2004 | Dollar Change 1979-2004 |
| Lowest fifth | $13,900 | $14,700 | 6% | $800 |
| Second fifth | 28,000 | 32,700 | 17% | 4,700 |
| Middle fifth | 39,900 | 48,400 | 21% | 8,500 |
| Fourth fifth | 52,300 | 67,600 | 29% | 15,300 |
| Top fifth | 92,100 | 155,200 | 69% | 63,100 |
| Top 1 Percent | 314,000 | 867,800 | 176% | 553,800 |

Source: Congressional Budget Office, *Effective Federal Tax Rates: 1979-2004*, December 2006.

## 4. Conclusion

Global inequality is decreasing as a result of a rebalancing between the North and the South which began nearly 25 years ago. There are many reasons to believe that this development is closely associated with globalization. Due to the strength of domestic markets in emerging economies, this rebalancing will not stop in the near future. While global inequality is on the decrease, however, in a number of countries inequality has increased. Is this a threat to globalization? If so, it is also a threat to global inclusion. We therefore have to address the rising levels of within-country inequality in whatever policies we seek to implement.

Social protection may be the answer to this issue, something that we do not have enough of at the global level. Even in some developed countries, such as the United States, there may not be enough. The adjustments which many countries have to make because of globalization may become more painful and politically more difficult than expected.

At the global level, there is also a need to improve international redistribution instruments such as development aid. More generally speaking, a greater level of development policy coherence is needed in developed countries

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