Democracy and Changes in Income Inequality

Kevin Sylwester*
Department of Economics, Southern Illinois University, U.S.A.

Abstract
This paper explores associations between changes in income inequality and the degree of both democracy and democratization. Countries with less democracy and those becoming less democratic have increasing income inequality although the relation is weaker within less developed countries.

Key words: income inequality; democracy; democratization

JEL classification: O15

1. Introduction

What are possible beneficial effects from countries obtaining greater levels of democracy? Since many would prefer to live in democratic communities, one obvious benefit is the increase in utility that freedom in various categories provides. But there might also be other advantages involving faster economic growth or a more equal distribution of income. Barro (1996) reports that the degree of democracy is nonlinearly associated with growth rates of income per capita. (See his paper for a survey of other studies examining how democracy and economic growth are related.) Li et al. (1998) report that countries with greater civil liberties have lower levels of income inequality.

Yet even without any such advantages, many people would still advocate a democratic way of life over one with fewer political or civil freedoms. Nevertheless, a better understanding of the economic and social effects of democracy and democratization can still help to determine what changes might accompany democratization versus what goals might need to be approached separately. For example, if democracy is beneficial for growth, then a poor nation having few political freedoms can expect faster economic growth should it enact political reforms. On the other hand, if the degree of democracy does not matter for growth, then a democratizing country needs to look elsewhere in order to find ways to foster faster economic growth.

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*Correspondence to: Department of Economics, Southern Illinois University, Carbondale, IL 62901, U.S.A. Email: keylwest@siu.edu. I would like to thank two referees for their suggestions.
omic progress is distributed across the society. Other things equal, most people would prefer to live in a community with a relatively equal distribution of income than in environments where income is skewed to a few. Likewise, government policies or environments that tend to further skew the distribution of income are often viewed unfavorably. Past research has also reported more tangible costs that income inequality exerts upon countries. Alesina and Rodrik (1994), Persson and Tabellini (1994), and Clarke (1995) report that income inequality is negatively associated with economic growth. [See Benabou (1996) for possible explanations.] Alesina and Perotti (1996) find that countries with more income inequality also have more political instability.

Many would argue that economic outcomes are dependent upon political conditions. In addition to any direct effect that political transformations have upon economic outcomes, these transformations might also precipitate important indirect effects through changes in the distribution of income. Justman and Gradstein (1999) argue that democratization in Britain led to subsequent reductions in income inequality. If true, then an obvious question is whether this holds for a larger sample of countries.

This paper examines how democracy and income inequality are associated within a cross section of countries. However, it takes a different approach than the one in Li et al. (1998). By using the change in income inequality instead of the level of income inequality as the dependent variable, it is hoped that one can better determine if democracies have a greater tendency to further reduce income inequality over time, not merely whether they have high or low income inequality at a point in time. By examining the change in income inequality over time, this paper uses a methodology similar to Savvides (1998) and Edwards (1998) although they study the association between changes in income inequality and protectionist trade policies.

I also examine whether countries that are democratizing have rising or falling income inequality. As a country undertakes various political reforms, does the dispersion of income become more or less skewed during this same period? Examining both the degree of democracy and its change is important because income inequality might evolve differently within an established democracy compared to a country that is still creating democratic institutions. Political transformations might entail further costs (or benefits) that are not found in more stable societies.

The paper is organized as follows. Section 2 discusses the income inequality data in detail. Section 3 presents the empirical methodology. Section 4 reports the findings. A conclusion follows.

2. Income Inequality

Income inequality data is taken from Deininger and Squire (1996). I use the Gini coefficient to measure the degree of income inequality as other measures of income inequality are not as prevalent across countries. Clarke (1995) reports that the Gini coefficient is strongly correlated with other measures of income inequality.
The sample period begins in 1970 (with the availability of higher quality data for the degree of income inequality) and ends in 1990. Since the distribution of income is likely to change only little during short periods of time [see Deininger and Squire (1996)], a twenty-year period is used to capture these changes. Not all observations are for exactly twenty years because data for income inequality is rarely available for every year in each country. If data is missing for 1970 or 1990, I use data from a nearby year. Although this means that I am using slightly different time periods for different countries, it is doubtful that the level of income inequality greatly changes over a few years.

The Gini coefficient is proportional to the area between the Lorenz curve and the 45 degree line. Each point on the Lorenz curve denotes what fraction of a country’s income goes to the first x percent of the population. The Lorenz curve is weakly rising between zero and one, lies weakly below the 45 degree line, but intersects the 45 degree line at 0 and 1. If the Lorenz curve lies along the 45 degree line, there is no area between the curves and the Gini coefficient is zero, denoting perfect income equality. As the Lorenz curve falls below this 45 degree line, the area between the two curves increases, thereby raising the Gini coefficient. A Gini coefficient of one denotes that all income goes to one individual. [As in Deininger and Squire (1996), the Gini coefficients given here are multiplied by 100.]

A change in the level of income inequality is measured in this paper by the change in the Gini coefficient, thereby indicating a change in the area between the Lorenz curve and the 45 degree line. An advantage of using the Gini coefficient is the availability of the data and the widespread use of the Gini coefficient as a measure of income inequality in other studies. However, a disadvantage of the Gini coefficient is that more than one Lorenz curve can produce similar Gini coefficients. Therefore, just because a Gini coefficient has changed little does not necessarily mean that there have been only trivial changes in the distribution of income. This concern is not unique to the use of the Gini coefficient. For example, if one uses a ratio of income of the top 20% to the bottom 20% of the population to measure income inequality, then one has less knowledge of changes in the middle of the distribution. Moreover, if two Lorenz curves cross, then it is often not clear as to which curve is “better” for social welfare. These concerns should be kept in mind when inferring how the distribution of income changes with each country.

My sample consists of 49 countries. The lack of a larger sample size is caused by a lack of compatible income inequality data for many countries. Not only must a country have data for 1970 and 1990 (or in one of the surrounding years), but these data points must be compatible with one another because I am considering the change between the 1970 and 1990 values of the Gini coefficient. For example, if one uses a Gini coefficient based upon expenditure data for 1970 but then uses a measure based upon income data for 1990, then it is unclear as to what extent a change in the level of measured income inequality is caused by using Gini coefficients obtained in dissimilar ways. Thus, if I use a Gini coefficient calculated from expenditure data for 1970, then I also use a Gini coefficient calculated from expenditure data for 1990. However, the data might still differ across observations. That is,
I use expenditure data for some observations but use income data for others. Some of the observations are also based upon urban surveys, although I use data from national surveys as much as possible. Nevertheless, I remain consistent in that urban data is used for both the 1970 and 1990 value if it is used for either one of them. Income inequality data can also be calculated using either the household or individual as the unit of analysis or can be calculated as gross or net of taxes. Although I use compatible data as much as possible, Deininger and Squire (1996) report that differences in data due to these additional divisions are likely to be small. Hence, I occasionally use both when calculating a change (e.g., household data is used for the 1970 measure and individual data for the 1990 level).

A copy of the income inequality data used here can be found in Sylwester (2002).

3. Methodology

Consider the following empirical specification:

\[ \text{CHGINI}_t = A^*X_t + b^*\text{DEM}_t + c^*\text{CHDEM}_t + v_t, \]

where CHGINI denotes the change in the Gini coefficient from circa 1970 to 1990.

In addition to a constant, matrix X contains the natural log of real GDP per capita in 1970 (GDP70) from version 5.5 of Summers and Heston’s Penn World Tables and the average number of years of schooling obtained in the adult population in 1970 (HUM70). Both are taken from Barro and Lee (1994) and are used to control for the level of development. I also include two dummies, AFRICA (sub-Saharan Africa) and LAMER (Latin America), to control for regional differences. Finally, X contains the initial level of income inequality, GINI70. Since the value for GINI70 is bounded between zero and 100, I add the Gini coefficient as a regressor in (1) since the magnitude of any change in the Gini coefficient is influenced by its initial value. A “high” Gini coefficient, for example, is unable to increase much further. DEM denotes the initial level of democracy and CHDEM denotes the change in democracy commiserate with CHGINI.

In past studies, democracy has been measured in two ways. The first accounts for civil liberties and considers factors such as: freedoms of expression and association, the presence of an independent judiciary and the strength of the rule of law, the security of property rights, personal autonomy, and social (gender, ethnic, etc.) equality before the law. In general, this measure attempts to account for legal and constitutional protections for individuals and their property. A second way to account for democracy considers political freedoms such as: open and fair elections, an independent legislature, rights of political organization, the presence of an opposition, and the potential for distinct groups within each nation to achieve self-determination and autonomy should they so desire. It is this measure that is more closely tied to electoral and political practices. Beginning in 1972, Freedom House provides annual country ratings according to both concepts of democracy:
civil liberties and political freedoms. Both are more commonly referred to as the “Gastil” measures of democracy. Each of the two indices takes integer values from one to seven with lower numbers denoting more democracy. (Go to www.freedomhouse.org for a more detailed description of their methodology and to obtain a copy of the democracy data used here.)

Below, I consider three measures of democracy, although I employ them in separate specifications. Each specification is similar to that in (1) except DEM and CHDEM are replaced by the concept of democracy being examined. Nevertheless, I continue to write “DEM” and “CHDEM” when making statements general to the three democracy measures.

The first measure of democracy accounts for civil liberties; CIV denotes the average civil liberty score from 1972 to 1974. The second measure, POL, spans the same period except considers political freedoms. Using averages lessens the danger that the results stem from some aberrant year in a country’s history. CHCIV and CHPOL consider the change in civil liberties and political freedoms, respectively, from their average value in 1972-4 to their average value in 1989-91. A value of two for CHCIV, for example, denotes that the civil liberties index (and more precisely, its average between 1972-4 and 1989-91) increased by two during this time span. It signals a move of two categories away from civil liberties. The third measure of democracy is simply a compilation of the first two and is denoted as COM and CHCOM, where COM = CIV + POL and CHCOM = CHCIV + CHPOL.

The specification in (1) includes both DEM and CHDEM (i.e., the initial level of democracy and its subsequent change) for three reasons. One, previous studies have focused upon the level of democracy, and so it becomes easier to compare my results with theirs. Two, all three indices of democracy are bounded from above and below, and so the initial value places constraints upon subsequent changes. If CIV equals seven, for example, then CHCIV cannot be positive. Therefore, it is important to include DEM when trying to uncover the association between CHDEM and changes in income inequality. Finally and as stated in the introduction, there might be interesting similarities or differences between democracies and countries that are democratizing. They need not have the same influence upon changes in the income distribution and so I want to examine the two explicitly. Just because established democracies might be better able to lower income inequality does not necessarily mean that a country that is becoming more democratic should also experience similar reductions.

A disadvantage of the specification in (1) is that the estimate of the coefficient c might suffer from problems of reverse causation or because CHDEM is otherwise endogenous. This issue will be discussed further in section 4.

Finally, in the empirical specification, the unobservable component in (1), v, has mean zero with finite but not necessarily identical variance across observations. Therefore, White’s heteroskedastic-consistent covariance matrices are used.
4. Results

Of the results in Table 1, some are robust across samples and democracy measures. Countries with initially high income inequality were more likely to see income inequality fall over time. The few sub-Saharan African countries in the sample saw their income inequality rise over this period. There is also evidence that Latin American countries saw their income inequality further increase. There is only weak evidence that higher income countries were more likely to see income inequality fall.

Table 1. Least Square Regression Results – Full Sample, Dependent Variable is CHGINI

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<td>COM</td>
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R² 0.6079  0.5991  0.6081  0.4415  0.6325  0.5990

# of obs. 49  49  49  49  49  49

Note: * denotes significance at 10% level; ** denotes significance at 5% level; *** denotes significance at 1% level. All regressions use White heteroskedastic-consistent covariance matrices. The regression in column (6) uses a constant, GINI, GDP, HUM, COM, AFRICA, LAMER, URB, POP, and OECD as instruments and is conducted by two stage least squares.

A perhaps somewhat surprising result is that countries with high human capital were less likely to see decreases in income inequality. More than one possibility exists to explain this positive association between human capital and changes in in-
come inequality. An obvious possibility is that high levels of human capital lead to more income inequality, but this might be an overly simplistic interpretation of the coefficient upon HUM70. Another possibility is that levels of human capital might be positively associated with dispersions in human capital, in which case this result would indicate some relation between education dispersion and increasing income inequality. A third explanation is that increasing human capital levels is a way to decrease income inequality, but this channel is less open to countries with already high levels of human capital. That is, countries with low levels of human capital can more easily reduce income inequality than can countries with high levels of human capital. In this case, the positive coefficient upon HUM70 does not imply that human capital leads to more inequality. Instead, the positive coefficient implies that societies where human capital is already high are less able to further reduce income inequality.

Note that the coefficient upon CIV is positive, suggesting that societies with fewer civil liberties were more likely to have subsequent increases in income inequality. CHCIV is also positive and significant, suggesting that countries where civil liberties diminished were also those with increasing inequality. These findings imply that both democracies and countries that were democratizing were more likely than their counterparts to see decreases in income inequality over this period. Findings regarding political freedoms are similar in that the coefficients remain positive but not as strong either in magnitude or in statistical significance. The findings with COM and CHCOM correspond more to those using civil liberties as the democratic index. To keep the presentation parsimonious, I only report future results using COM and CHCOM to measure democracy, although the same pattern that begins here continues. Findings with CIV and CHCIV remain strong whereas those for POL and CHPOL are not as strong and in some cases are statistically insignificant (although the coefficients remain positive).

One concern is that differences as to how the income inequality data were collected are skewing the findings. To try to control for these differences, the following dummy variables were created. NET takes the value one if the Gini coefficient was calculated net of taxes and takes the value zero otherwise (gross of taxes). EXPEN takes the value one if the Gini coefficient comes from expenditure data and takes the value zero otherwise (income data). INDIV takes the value one if the Gini uses the individual as the unit of analysis and takes the value zero if the household is the unit of analysis. Finally, DIFFER takes the value one if the 1990 Gini differs as to how it was constructed from the 1970 data and takes the value zero otherwise. Although the coefficient upon NET was statistically significant, the inclusion of these controls does not alter the findings of the paper, and it is less likely that these differences in how Gini coefficients were constructed are what is driving the findings. (Results are available from the author upon request.)

The later specifications in Table 1 conduct other robustness checks. Column 4 removes the initial level of income inequality, GINI, from the specification. Doing so decreases the magnitude of the coefficients upon COM and CHCOM, although they remain positive, albeit insignificant at conventional levels. However, this speci-
fication is not appropriate if subsequent changes in the Gini coefficient are influenced by its initial level. Although not presented, CHCIV remains significant at the 10% level in an analogous specification.

The specification in column 5 adds the government share of GDP across the period using the Summers and Heston version 5.5 data (GOV) and the average number of coups from 1970 to 1985 (COUP). Both are from Barro and Lee (1994). I include the former since democracies and dictatorships might enact different policies regarding government expenditures. I include the latter since movements towards or away from democracy might be brought about by political instability which might then affect the distribution of income. According to the estimates, neither possibility is driving the previous results as the coefficients upon COM and CHCOM increase slightly.

As stated in Section 3, a danger stemming from the empirical specification is that reverse causality might be driving the results. Bourguignon and Verdier (2000) present a model where income inequality influences the pace of democratization within a country. Falkus (1997) describes how rising income inequality created conditions that undermined democracy in Thailand. A difficulty, however, in trying to limit the possibility that reverse causation from CHGINI to CHDEM is driving the above results is finding suitable instruments for CHDEM. Ideally, one would like to acquire data on a country characteristic that is associated with a change in the degree of democracy but is not associated with changes in income inequality after taking into account the other control variables (i.e., the characteristic is not associated with \( v \) from (1)). Given this difficulty of finding suitable instruments, the following specification and results should be treated with caution.

One possible instrument is an OECD dummy which takes the value one if the country was in the OECD (Organization of Economic Cooperation and Development) in 1970 (or joined soon thereafter) and takes the value zero otherwise. Since many OECD countries were true democracies in 1970, they rated as “one” in the Gastil measures and so could not have negative values of CHDEM. On the other hand, (1) already controls for initial levels of income, human capital, and democracy, thereby lessening the danger that OECD is correlated with \( v \). Sylwester (2002) uses a similar specification as (1) but includes OECD as a regressor and finds the coefficient upon OECD to not be statistically significant. Other instruments for CHDEM include the natural log of the population density in 1970 (POP) and the urbanization rate in 1970 (URB). Vassilev (1999) and Lee (1991) provide examples of how urbanization influenced democratization in Bulgaria and Taiwan, respectively. Here, I assume that population density and urbanization do not have associations with changes in income inequality aside from working through the other control variables.


Column 6 presents findings using these three variables as instruments along with the other control variables from (1). The coefficients upon both COM and
CHCOM remain positive although they are slightly greater in magnitude than before. Both remain statistically significant at conventional levels. Although the strength of these findings depends upon the appropriateness of the instruments, this does provide at least some evidence that the causality runs from changes in democracy to changes in income inequality. Unfortunately, higher standard errors lessen the precision of the estimates.

Table 2 limits the sample to the lesser developed countries (LDCs) and reports results from regressions analogous to the ones in Table 1. The only change in methodology is that the instrument list for the regression in column (6) does not contain OECD since there are no OECD countries within the sample. Although the respective coefficients upon the democracy variables remain positive, the findings are not as strong as they were before, especially for the 2SLS regression. When only URB
and POP (along with the other control variables) are used to instrument for CHCOM, the coefficients upon COM and CHCOM are large in magnitude (6.58 and 9.17, respectively) but are not significant at conventional levels. Therefore, the association between the democracy measures and CHGINI is potentially large, but their coefficients are imprecisely estimated, thereby preventing stronger conclusions from being made.

There is more than one possible explanation for the weaker results found in Table 2. The first is due to the smaller sample size, thereby leading to greater imprecision and higher standard errors. Hence, evidence for associations between the regressors and the dependent variable is weaker. Another potential reason is that the OECD countries are a more homogenous group of countries than are the LDCs, and so political changes (or lack thereof) within OECD countries are more likely to have uniform effects than within the group of LDCs. Consequently, the findings are stronger with the inclusion of the OECD countries.

Both of these explanations may be playing a role. In the first five regressions of Table 2, the coefficient upon CHDEM is higher in magnitude than its analog from Table 1, although its statistical significance is lower because of the less precise estimates. On the other hand, the coefficient upon DEM is both lower in magnitude and in statistical significance than its counterpart in Table 1. Once many of the democracies are removed from the sample, the association between democracy and changes in income inequality weakens. In the last column, little can be concluded due to the high standard errors, and one possibly needs to find more appropriate instruments for these LDCs.

Nevertheless, even though the findings are weaker regarding the LDC sample, there is no evidence that democracy or democratization is associated with increasing income inequality.

5. Concluding Remarks

These results have generally established a negative association between changes in income inequality and both the level of democracy as well as the degree of democratization. The 2SLS findings provide evidence that the causality runs from democratization to changes in income inequality.

These findings have important policy implications, especially in light of people’s preferences towards democracy and narrowing income disparities. One implication stems from the positive coefficient on the initial democracy index, suggesting that countries with less democratic freedoms are more strongly associated with subsequent increases in income inequality. If one allows for a causal interpretation, then the findings suggest that democracies relative to authoritarian regimes have been more able to reduce income inequality. Perhaps democracies are more likely to enact policies beneficial to low income groups. Another (perhaps complementary) possibility is that those few holding political power in dictatorships use this power to further enhance their wealth and income at the expense of lower income, less powerful groups. Although this study did not examine why income inequality decreases more
in a democracy, this finding can still be of benefit since it provides further impetus to those arguing for democratic reforms. There is no evidence that income inequality is more likely to rise in democracies than in dictatorships.

The second implication from this study is that countries that were in the process of democratizing also were associated with lessening income inequality. This finding does not necessarily follow from the first. Political change can create instabilities and transformations that probably do not have unambiguous effects upon the denizens of that country. Therefore, it is not a priori clear as to what is happening to the distribution of income in countries experiencing such evolutions. Nevertheless, the findings show that countries that became less democratic were also more likely to have rising income inequality over this same period. Advocates of political change might be concerned about negative transitional effects upon economic growth and the income distribution. The above results suggest that less concern needs to be placed upon the latter. Even if there is no causal association from democratization to income equality (although the 2SLS results suggest otherwise), the lack of any negative association implies that such political transformations at least do not raise income inequality.

As before, the methodology employed here does not convey why such results hold. Why might democratization lessen income inequality? This is an important question as researchers and policy makers try to better understand the links between the two. Unfortunately, it is also a question for future research.

Appendix

The countries within the two samples are given below.

Lesser Developed Country (LDC) Sample: Bangladesh, Brazil, Chile, Columbia, Costa Rica, Dominican Republic, Ecuador, Egypt, El Salvador, Honduras, India, Indonesia, Iran, Jamaica, South Korea, Malaysia, Mexico, Pakistan, Panama, Philippines, Singapore, South Africa, Sri Lanka, Republic of China (Taiwan), Tanzania, Thailand, Tunisia, Turkey, Uruguay, and Venezuela.

Full Sample: LDC Sample plus Australia, Canada, Denmark, Finland, France, West Germany, Greece, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, United Kingdom, and United States.

References


