Addressing India’s income inequality

Thomas Piketty has thrown a flaming dart into the Indian economic debate. In a new paper written in collaboration with Lucas Chancel, the superstar French economist has shown that income inequality in India is now at its highest level since income tax was first levied in 1922. The title of the study is suitably eye-catching—*Indian Income Inequality 1922-2014: From British Raj To Billionaire Raj*. The data here has quite naturally sparked off a lot of excited debate about the nature of Indian economic policy.

Indian inequality data has traditionally been derived from consumer surveys that understate the extent of the problem. Chancel and Piketty have calculated inequality from tax data, national income accounts and sample surveys—a much better method, though the way these disparate data sources have been integrated leads to potential methodological tangles that could lead to an overstatement of the extent of inequality in India. For example, the use of tax data for the top 5% and the use of survey data for the rest of the population assumes that only the top sliver under-reports income. How realistic is that?

The two economists show that income inequality has been rising steadily since Rajiv Gandhi became prime minister. This is not a unique finding. The International Monetary Fund has earlier estimated that the Gini coefficient, a popular measure of inequality, rose from 45 to 51 between 1990 and 2013. The LIS Data Centre in Luxembourg has come to similar conclusions. These are far higher than the official Gini estimate of 37 derived from consumer surveys.

The most obvious conclusion to be drawn is that economic reforms have relatively benefited a tiny group at the top of the Indian income pyramid, though absolute incomes have gone up across deciles since 1980 while the poverty ratio has plummeted. However, the uneven distribution of higher growth needs more public attention.

There are two important lessons to be gleaned from a careful reading of the data that has been released. First, the increase in income inequality coincides with the sharp rise in Indian economic growth after 1980. Also notice the very significant drop in income inequality during the stagnant 1970s. This points to the famous hypothesis put forth by Simon Kuznets—that inequality tends to rise during periods of rapid growth thanks to the uneven pace at which people move from low productivity to high productivity activities. Piketty wrote a sharp critique of the Kuznets hypothesis in Capital In The Twenty-First Century, his wildly popular (but perhaps unread) book. The correlation between economic growth and income inequality since 1965 needs to be worked out in a statistically rigorous manner.

Second, income inequality is not just about the share of national income going to the top 1%. There are deeper distributional issues. A comparison with China tells us a lot. Chancel and Piketty show that the share of national income captured by the bottom half in both India and China after 1980 has been broadly similar. The big difference between the two countries is in the fact that the middle 40% in India got 23% of the increase in national income since 1980 while the same group in China got 43%—a massive gap of 20 percentage points. This difference of 20 percentage points was largely captured by the top 1% in India.

So a stylized view is as follows: The Indian top 1% has done extremely well, the Chinese middle has benefited far more than the Indian middle, and the bottom half in both countries has had broadly similar experiences.

This newspaper believes the answer to this paradox lies in the failure of labour-intensive manufacturing in India compared to its massive success in China. The latter could absorb millions

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of people who left farming because of the rapid expansion of large enterprises, as was the case in most other successful structural transformations in Asia. India has failed on this front. The proportion of the labour force in agriculture has come down, but the workers who have left farms have not got jobs in modern factories or offices. Most are stuck in tiny informal enterprises with abysmal productivity levels.

There are two major political economy lessons that flow from these trends. First, that a sustainable attack on mass poverty should be focused on job creation in the modern sectors of the economy rather than redistribution through fiscal spending that is eventually destabilizing. Second, widening income inequality weakens public support for liberal economic reforms, as economist Dani Rodrik has shown. Economic populism takes over, as was the case during the tenure of the second United Progressive Alliance government led by Manmohan Singh. The gradual drift of the Narendra Modi government in the direction of populism and interventionism deserves to be seen against this backdrop.

It is also apt to once again underline the historical fact that no country has been able to win the battle against mass poverty without rapid economic growth. China is the latest example. Inequality is a problem that deserves more public attention—but the solution is more inclusive growth rather than misplaced nostalgia for the miserable 1970s.

How can India reduce income inequality? Tell us at views@livemint.com

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