Title: A proper farewell to Kuznets’ hypothesis

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Extended Abstract

The aim of this paper is to offer a more appropriate test of Kuznets’ “inverted-U” hypothesis than the one routinely used in the literature and implement it using panel and country-by-country regressions. We explore whether countries experiencing important structural changes, as reflected by changes in the share of the population living in urban areas, see an evolution of income inequality along the lines discussed by Kuznets (1955).

In an enormously influential article, Kuznets (1955) speculated that income inequality should first rise and then fall as countries progress from low to high development status. This “inverted-U” hypothesis became one of the most widespread notions in development economics. Kuznets was very clear as to why such an evolution could be expected; and his thought was clearly embedded in the dominating notions of economic development of the 1950s. At this time, development and industrialisation were almost synonyms, and the process of economic development was universally seen as the process which transfers labor from a “traditional”, low productivity, rural sector (read agriculture) to a modern, high productivity, urban sector (read industry).

Kuznets (1955) explained how shifts in the labor force from agriculture to industry, or from rural areas to urban ones, would potentially affect inequality. He even presented a simulation exercise to illustrate his point. Later contributions (Robinson 1976, Anand and Kanbur 1993) made more rigorous attempts at modelling the process.

Given the above description, the obvious way to test for Kuznets’ hypothesis would be to see if the level of income inequality in a country is related to measures like the proportion of the population living in rural areas or working in Agriculture. Interestingly, this has not been the route chosen by any of the very numerous empirical studies on Kuznets’ hypothesis over the last five decades. All the econometric studies we are aware of have chosen another, less direct, route to testing: regressing measures of income inequality on income per capita.

Interpreting Kuznets’ hypothesis as a relationship between income per capita and inequality is misleading, as the “fundamental” cause of changes in income distribution would be shifts in population across sectors. Of course, it might well be the case that the structural transformation of an economy from agriculture to industry is accompanied by a rise in income per capita. In this case income per capita could be considered a “second best” variable to be used in the absence of data on the structure of the economy. But income per capita can be affected by many factors besides the shift of population across sectors. There is no obvious reason why a change in income
per capita should affect inequality by itself, so one should be cautious when interpreting the results from this methodology.

This paper distinguishes itself by taking the mechanism proposed by Kuznets seriously and testing whether the shift of population from rural and agricultural areas towards urban ones has an effect on income inequality. We do this by using a large panel data set on income inequality selected from the “World Income Inequality Database” (UNU-WIDER) and data on urban population from the “World Development Indicators” (World Bank).

Most countries have experienced a shift of population from rural to urban areas over our period of analysis: 1960-2003. Are these shifts related to changes in income inequality in any systematic manner? We start by pooling the data for a large set of countries and look for an effect of the share of urban population on inequality. We consider the whole sample of countries and then several different subsamples: low, middle and high income countries, Latin America, sub-Saharan Africa, and other geographical regions. In the analysis we deal with the issue of comparability of different estimates by including fixed effects not just for every country but for every series of estimates on inequality.

Finally, we search for a Kuznets curve on a country-by-country basis. This can be done only for a limited number of countries where: (a) Enough data on income inequality exist and (b) The economy experiences significant shifts in labor over the period where we observe the inequality measures.

References