Inequalities in the BRICS

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Introduction

The recent bestseller by Thomas Piketty, *Capital in the Twenty-First Century* (2013, English edition 2014), has sparked wide interest in social inequality. Piketty argues that the world today is returning towards "patrimonial capitalism", in which much of the economy is dominated by those who have inherited wealth: their power is increasing, creating an oligarchy. He even proposes a global system of progressive wealth taxes to help reduce inequality and prevent the vast majority of wealth coming under the control of a tiny minority.

While Piketty's work is mainly based on the experiences of mature and developed countries, the situation of some fast-growing economies, such as Brazil, Russia, India, China and South Africa (the so-called BRICS countries), seems a little different. Indeed, when China started its open-door policy 30 or so years ago, then leader Deng Xiaoping, in particular, stressed "allowing a small portion of the population to get rich first". What's more, many developing countries in the early years of their economic development provided widespread subsidies for the rich — those fortunate enough to be business owners — such as the policies applied in Special Economic Zones (SEZ) where tax holidays, export and import subsidies, and land-use subsidies are common, hoping to enlarge the pie for the whole country. Some of these countries have achieved great success with such policies and become the so-called "fast growing economies".

Yet, their income inequality has also been rising rapidly. The *China Daily* (May 23, 2012) reported that the most affluent 10% of the population makes 23 times more than the poorest 10%. Further, the Chinese Gini coefficient remains well above the warning level of 0.4 set by the United Nations, peaking at 0.55 in 2002 and still at 0.47 in 2012. The Gini coefficient in South Africa was 0.67 in 2008, followed by Brazil (0.51 in 2012), Russia (0.41 in 2011), and India (0.34 in 2009). But the inequality in two countries, China and Russia, is still rising.

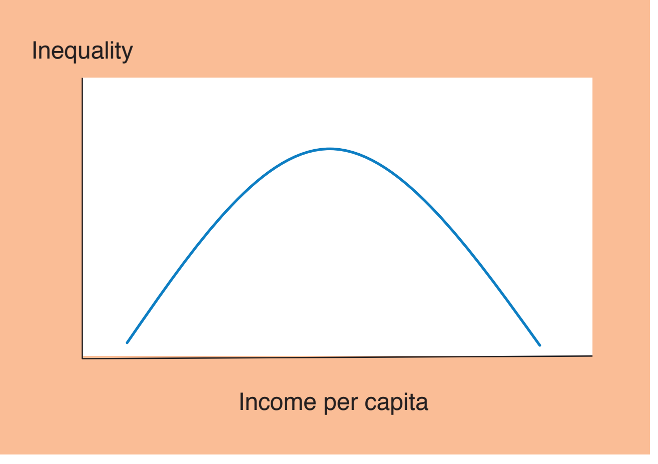
Is Inequality Always Bad?

Given these contrasting stories, one naturally asks whether inequality is a necessarily bad phenomenon, especially for the poor. If one visits the emerging economies, one should see that the rapidly expanding cities need cheap labor, which mostly comes from the countryside. The big cities are few, but the countryside is vast. On the one hand, the vast rural areas provide an almost "unlimited supply" of cheap labor; on the other hand, if one is fortunate enough to have a business, a house or some other property in an expanding city, one gains not only from increased work income, but most likely also from the rapidly rising price of property.

In fact, some 60 years ago, economist Simon Kuznets proposed the hypothesis that as an economy develops, market forces first increase and then reduce economic inequality, forming the basis for the so-called "Kuznets curve" *(Chart)*. As cities grow bigger, rural workers migrate in on a large scale for better opportunities. Workers' income would grow, but at a much slower speed than that of capital owners, causing inequality to increase. According to Kuznets, inequality is then expected to decrease when a certain level of average income is reached, as industrialization and democratization give rise to a welfare state, allowing for a trickle-down of the growth benefits to low-income workers and increasing the per capita income of everyone in the country.

To put this logic into bookish jargon, as assets are accumulated and reinvested, diminishing returns kick in and the demand for labor increases, raising the wage rate. Households save and invest more when they become richer, thereby increasing capital accumulation and eventually generating a trickle-down effect to the poor in the long run. This mechanism increases the capital stock, the

CHART
Kuznets curve



Source: Compiled by the author

productivity of workers and the welfare of all households including the poor when the rich becomes richer. Also, innovation is the engine of growth. Extra profits must be paid for entrepreneurs to take risks, to try and if they fail, to try again. Hence, in contrast to the alarm caused by Piketty, inequality may not be so bad after all; on the contrary, it might just be a "growing pain" or even a "necessary evil" on a country's catching-up path, in order to increase the incentives for investment in innovation and eventually enlarge the total pie.

However, this does not mean inequality is not a concern for governments at all. Whether a country gets to the right-hand side of the Kuznets curve — when inequality declines as income per capita grows — is not automatic. Instead, it depends on several important factors. Some countries may even get stuck in the so-called "middle income trap" and spend decades to fight inequality.

Specific Causes of Inequality in BRICS

First, one needs to look for the specific causes of inequality in each of the BRICS countries.

Brazil: Brazil is notorious for having a high Gini coefficient, even though it dropped from 0.596 in 2001 to 0.51 in 2012. The country's high income concentration is depicted by the richest 1% of the population (less than 2 million people) having 13% of all household income. There are basically three reasons for the high income inequality: racial divide, urban-rural divide and unfair taxation. About half of the population is black, many of whom live in the poor urban favelas and remote rural areas, lacking health care and proper education. Brazil also heavily taxes consumer goods, including food, which leaves a bigger burden on the poor than the rich. The depletion of nearby offshore oil reserves and the recent fall of petroleum prices only make things worse, depriving the government of the necessary funds to build better infrastructure, health care and education.

Russia: In Russia, inequality was immediately born after the big bang in the early 1990s, when state property was privatized in a hurry and social wealth went into the hands of a few oligarchs. Many of the prime factories and mines ended up in the hands of a few people who had access to a lot of capital and were politically well connected, at very cheap prices. Since 2000, the number of billionaires has grown at a staggering rate. According to the Forbes list, there were no dollar billionaires in Russia in 2000. But by 2003 there were already 17, and by 2008 this figure had risen to 87. Since the crisis of 2008, another 23 billionaires have joined the list. In 2013, the Global Wealth Report by Credit Suisse recorded that 35% of the country's total wealth is in the hands of 0.00008% of the population.

The surging inequality in Russia reflects the inability of a weak government to carry out any effective redistributive social policy. It creates many problems, such as rampant corruption, outdated infrastructure, ruined health and education systems, and a shortage of professionals. These problems are aggravated by the recent decrease of petroleum prices. A most serious problem is the decay in morale that leaves young people in despair and hardly able to face the reality of insurmountable inequality. The suicide rate among teenagers in Russia is among the highest in the world, overtaken only by Kazakhstan and Belarus. According to UN figures, 22 out of every 100,000 Russian youths commit suicide. This compares with an average of just seven worldwide.

India: According to the World Bank, the Gini coefficient in India was 0.339 in 2009, the lowest among BRICS countries. Still, Indian officials suggest that the income disparity can be accounted for by India's improperly shaped agricultural and rural safety nets. Rural infrastructure such as power, roads and transport facilities are in a poor state, while market forces are acting in favor of urban India, which is why income inequality is rising. Also, people working in unorganized sectors are characterized by low wages, long working hours, and a lack of basic services such as first aid, drinking water and sanitation.

China: According to the Institute of Social Science Survey at Peking University, the income inequality among Chinese mainland citizens reached a severe condition in 2014, with 1% of the Chinese population possessing one-third of the country's wealth.

Inequality in China is mainly institution driven. First and foremost, it is the Chinese household registration system — *Hukou* — that divides the population into urban and rural residency by birth, and gives systemic benefits to urban residents and nothing to rural residents. The *Hukou* system creates an urban-rural divide and a big city-small city divide. For the urban-rural divide, traditionally, China adopted a centrally planned system that favored heavy-industry development and extracted agricultural surplus largely for urban capital accumulation and urban-based subsidies. In the 1980s and 1990s, state investments in the rural economy accounted for less than 10% of the budget, despite the fact that the rural population was about 73-76% of the national total. For the big city-small city divide, under the original strict *Hukou* control, even if one has urban status, it is extremely hard to migrate from a smaller city to a bigger one, the latter of which has much better benefits in education, health care, infrastructure, and cultural and sports facilities. Even today, the chance of getting into Peking University and Tsinghua University (arguably the best two universities in China) is about 30-50 times higher if one has Beijing *Hukou* rather than an urban *Hukou* from a remote province such as Guangxi or Guizhou.

Also, regional inequality in China is increasing fast, especially between coastal provinces and inland provinces. A study found that variations across Chinese provinces account for more than 10% of the country's overall income inequality. Between 1989 and 2004, income in coastal provinces more than tripled whilst that in inland provinces doubled. Since being a coastal province is a geographic advantage that will persist, this tendency for divergence will most likely continue for quite some time. Economists Ravi Kanbur and Xiao Zhang explain that the widening of regional inequality comes from the "greater ease of rural-to-urban migration within provinces, compared to the institutional and other difficulties of migrating from inland to coastal provinces". Due to the easing of *Hukou* control and peasant migration to cities, a new trend is emerging. Rural incomes are less equally distributed than urban incomes among the original urban *Hukou* holders and newcomers, and urban inequality is increasing faster than rural inequality.

In addition, the recent housing market boom, coupled with institutional factors, greatly contributed to rising inequality. Under the hierarchy of the centrally planned system, rural areas are sacrificed for the development of urban cities, and small cities are sacrificed for bigger cities. To be more specific, the whole country is sacrificed for the national capital, Beijing, the whole province is sacrificed for the provincial city, and the whole district is sacrificed for the city where the district government is located. The *Hukou* limits the number of people migrating to a higher level in the hierarchy. The price of a property in a big city includes not only the normal value but also many privileges that result from sacrifices made by lower hierarchy people, which are provided by the government through *Hukou* control, such as better opportunities for education, health care, infrastructure, entertainment and sports. When the *Hukou* system started to ease and the central government executed several rounds of easy-money policies, urban housing prices increased by 10-fold or more, and the holders of urban status greatly benefited, while the late comers (mostly rural migrants) generally gained nothing. What's more, since the housing bubble is absorbing so much wealth, further monetary easing has become totally ineffective in generating economic growth. On the contrary, businesses stop new investment, and some even close factories that have been providing jobs for migrant workers. Instead, they flock to buy more housing, further enlarging the housing bubble.

South Africa: Many of the inequalities created and maintained by apartheid still remain in South Africa, but have begun to be deracialized somewhat. Post-apartheid, the country has conducted land reform, redistributing to blacks from white owners. Also, government investment in education has increased, accounting for a full 7% of GDP.

Poverty in South Africa is still largely experienced by the black population, who make up over 90% of the country's poor even though blacks are 79.5% of the country's total population. A comparison of data from the 2008 National Income Dynamics Study and the 1993 Project for Statistics on Living Standards and Development found that income inequality had increased in total and within each racial group. However, inequality between the racial groups has decreased. In 2008, the wealthiest 10% earned 58% of the total income, and the top 5% earned 43% of the total income. This is worse than in 1993, when the top 5% earned 38% of the total income.

This biggest cause of rising inequality in South Africa is unemployment, especially in the declining manufacturing industry. Historically disadvantaged groups like rural populations, women, and blacks experience higher rates of unemployment. Modern South Africa relies heavily on wealth and foreign investors to fuel its economy, spurring policies that favor these groups and consequently enlarging inequality.

Outcome Inequality or Opportunity Inequality?

Second, one always needs to ask, is it outcome inequality or opportunity inequality? People are more tolerant of outcome inequality, since it depends on one's ability, efforts, location or even luck. But opportunity inequality is mostly caused by institutional factors. If there is prolonged discrimination in the system, no matter how hard one works, inequality cannot be overcome. The Chinese *Hukou* system is such an example. It is extremely hard to obtain urban status in the mega-cities like Beijing and Shanghai, where benefits are much better than in other cities and regions within China. Even today, one cannot buy an apartment in Beijing or Shanghai without *Hukou* there, becoming totally deprived of the opportunity to benefit from their skyrocketing housing markets. It is said that to work hard for 40 years does not earn as much as to hold an apartment in some areas of these cities for four years. Such opportunity inequality demoralizes society, possibly creating ghettos of despair in the vast countryside. In fact, not long ago, a woman killed four of her children in the northwest province of Gansu before committing suicide out of poverty and despair, and the next day her husband also committed suicide.

Does Redistribution Work Well?

Third, we need to consider the redistribution system, including taxes, education, and land reform. Tax systems in developing countries are usually imperfect or even nonexistent, making these governments unable to carry out redistributive social policies. For example, China does not have a property tax, and coupled with the recent housing price bubble, inequality has skyrocketed between home owners in mega-cities and migrant workers or rural peasants.

By contrast, the East Asian Tigers — Japan, South Korea, Hong Kong, Taiwan, and Singapore — achieved equality quickly during their rapid growing periods in the 1960s-1990s, and are good examples for other developing countries to follow. Life expectancy increased, while illiteracy and populations living in absolute poverty decreased quickly. Economist Joseph Stiglitz argues that these can be explained by the immediate re-investment of initial benefits into land reform (increasing rural productivity, income, and savings), universal education ("intellectual infrastructure" for productivity), and industrial policies that distributed income more equally through high and increasing wages and limited the price increases of commodities. These factors increased the average citizen's ability to consume and invest within the economy, further acting as a feedback loop by contributing to economic growth.

Property Rights Protection

Fourth is the issue of property rights protection, including intellectual property rights. In this age of globalization, profits will escape quickly to other countries if property rights are not properly protected. Then even if wealth is somehow initially accumulated, it will not benefit domestic residents. Rather, it will run to rich countries where property rights protection is well enforced. Even worse, rich people and entrepreneurs will run with their wealth, taking factories and other production facilities with them, eventually hurting the workers and the poor. Such a phenomenon has been rampant in China in the past few years, forcing the central government to sell foreign reserves in large quantities to defend the renminbi.

Effect of Technological Progress & Globalization

Fifth, technological progress and globalization also affect inequality in different ways. Technology improvement made it possible to slice the whole production process into many smaller and mostly sequential parts (or tasks), especially following the telecommunication and Internet expansion of the late 1990s. This technology revolution created an enormous, reliable and affordable communication and coordination infrastructure, which firms can utilize to reorganize production and seek the highest efficiency on a worldwide scale. As such, even a small country can contribute to the total complicated production process by specializing in a small task, such as the production of a small component, benefiting from the global production chain, whereas with *ex ante* technology improvement, a country has to manufacture the whole product in order to export. In other words, technology improvement makes it easier for small countries to identify and create their own comparative advantage, especially in manufacturing and services. The biggest gainers from offshoring in the past two decades are perhaps China and India, with the former becoming "the manufacturing center of the world" and the latter becoming "the call center of the world" and "the IT center of the Orient". Globalization and offshoring also contribute to regional and sectoral inequality within a country. Regions and sectors that are more open, with better property rights protection, possessing more educated and skilled workers and that are coastal rather than inland benefit more and faster.

Social Problems of Inequality

Finally, social problems can arise if inequality exceeds some critical level. As mentioned earlier, while the extremely poor may become desperate, leading some of them to commit crimes, the extremely rich may start to lead decadent and lavish lives, wasting resources and providing bad examples to society. In addition, corruption always comes hand in hand with surges in wealth. It is rumored that the logic of a corrupt Chinese official goes like this: "I was much smarter in school than the idiot who just became a billionaire, and I worked just as hard. Why should he become rich while I am just a poor civil servant?" Morally, he thinks it is acceptable to take bribes, and it is easy for the super-rich to give bribes because their money comes too easily.

Due to the sudden increase in inequality, a phenomenon dubbed "curses to the late comers" may arise. In order to get rich fast, some people may take the easy way out. Some of the "curses" can be found in the following examples. In China, many newly constructed roads, railways, bridges, buildings and even food products are of poor or even hazardous quality, and have caused fatal accidents, and some have to be torn down within a short period after construction. Public morality seems to be in a landslide, typified by the death of a two-year-old girl in October 2011 who was run over twice by vehicles and subsequently ignored by 18 cyclists and other passersby (a rag collector eventually came to her aid). These phenomena have generated heated debates in the media, among policy makers and researchers alike. There are soul-searching cries in the popular press that China in its rush to modernity should slow down its pace, in order to lessen man-made errors and potential disasters, make more efficient use of its depleting resources, and reduce the ever increasing inequality.

In the bigger picture, less developed countries in their rush to chase rich countries may pick the easier way by copying mature technologies and buying assembly lines, instead of taking the more difficult route of gradually developing institutional and political systems conducive for innovation and sustainable growth. As such, simple expansion may be fast, but it will be very costly and short-lived, and inevitably come with various kinds of social inequalities due to the lack of fair institutions and systems. JS

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