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What are income and wealth?

A number of key concepts are essential to any discussion of income inequality. These include the distinction between income and wealth as well as definitions and measures of inequality and poverty.

Key themes

For centuries, the nursery song “Tinker, Tailor” was used by children to determine who they might marry. Counting out cherry stones or daisy petals, they would chant a still familiar rhyme:

*Tinker, tailor, soldier, sailor,
Rich man, poor man, beggarman, thief.*

With origins that can be traced back to at least 1475, the song is a reminder that, in much of human history, some level of economic inequality has been a recurring theme. In other words, some people have usually had more than others. But the extent of this inequality has varied considerably. Today in northern Europe, for example, the gap between rich and poor is still relatively narrow compared to other developed countries. In other countries, such as the United States and Turkey, China and in Central and South America, it's typically much wider.

Why does this matter? Later sections will explore the impacts of income gaps on our economies and societies. But, for now, it's enough to say that we need to understand how economic resources are spread across society to determine the extent to which people are in the economic mainstream or on its fringes.

To develop a full picture of people's economic resources, two concepts are particularly important – **income and wealth**. Income is the flow of money that comes into a household from employers, owning a business, state benefits, rents on properties, and so on. Wealth essentially represents people's savings and it's typically higher – and spread out more unevenly – than income. Wealth matters but, in some ways, income matters more. That's because it's usually a better indicator of people's day-to-day economic resources.

The task of *measuring income (and wealth) inequality* is challenging. It's hard, too, to represent the results in a meaningful way. Today, the most widely used measure is the Gini coefficient. But the Gini only shows part of the story. While it gives a good overall sense of income distribution, it doesn't show us how many people are lacking even basic resources. For that reason, inequality measures are usually supplemented with *measurements of poverty*.

1.1. Income vs. wealth: Similar but different

Income and wealth are often used interchangeably but they're not the same. A pensioner living in a house valued at \$500,000 might be considered wealthy, but if her pension brings in just \$100 a week, most would consider her as having a low income. This is why it's important to understand the difference between income and wealth.

What is income?

People sometimes think of their before-tax salary as their income, even though it's rarely the same as what they actually receive into their hands each month. So, instead, it's useful to think in terms of *disposable income* (or income after taxes and transfers), which gives a much clearer sense of how much money people actually have available to them to spend on rent, food, clothes and so on.

In basic terms, disposable income is determined by the flow of money into a household (usually salaries and payments from the state) minus what goes out in taxes. Think of it as “incomings” and “outgoings”:

- ▶ The incomings side can include salaries or wages, earnings from investments and rents on properties. It also includes direct benefits, or transfers, received from the state, such as child benefits. Some measures of disposable income also include non-cash benefits from the state, such as education or healthcare – an important benefit for many families.

- ▶ The outgoings side typically includes taxes and other charges, such as social security, that are paid to the state as well as some payments to other households, such as to divorced spouses.

The difference between *market* income (i.e. income before taxes and transfers) and *disposable* income is substantial in most OECD countries. Without taxes and transfers, inequality would be even higher than it currently is (see [Section 3.5](#)).

Income is also often discussed in terms of “equivalised household income” or “household per capita income”. To explain: Households vary greatly in size – in a wealthy country, an income of \$10,000 might be enough to support someone living on their own but could pose problems for a family of four. That’s not to say that such a family needs four times what a single individual needs – one TV set, one fridge should be enough to meet their needs. But such economies of scale don’t apply quite so much in other areas, like clothing and food. The equivalised figure takes account of all this. It’s computed by dividing household income by the square root of the household size. So, according to standard economic calculations, to match that income figure of \$10,000 for a single person, a family of four would actually need an income of \$20,000 to reach the same level of well-being.

More from the OECD: How does your income compare with everyone else’s? And how well do you understand how income is spread out across society? Get the answers with the OECD’s Compare Your Income tool: <http://www.oecd.org/statistics/compare-your-income.htm>.

What is wealth?

Most people have an instinctive feeling of what wealth means – money in the bank, property and land, shareholdings, jewellery and art, pension rights and possibly life assurance, and so on. But wealth has both a positive and a negative aspect. As well as assets, like our savings, we may also have liabilities, such as loans and mortgages. Combine these assets and liabilities and we come up with a picture of people’s net wealth.

Wealth is important for several reasons: It gives people a cushion if they lose their job or fall on hard times; it can also provide a source of income, for example, through interest payments on bank deposits or dividends on shares; and it allows people to make one-off or large-scale investments, such as in their education or in property.

Measuring wealth is a complex business, and not all countries do it the same way – for example, some may include the value of a pension, others may not. For this reason, it's important to look at the fine print of any measure of wealth to see what's included and what's left out.

Comparing wealth and income

Because wealth is accumulated over time, it's unsurprisingly typically higher on average than income. For example, in OECD countries average household disposable income per capita is \$25,908 a year but average household net financial wealth per capita is \$67,139.

A second feature of wealth is that it's typically spread out even more unequally than income – in other words, wealth inequalities tend to be more pronounced than income inequalities. Why does this matter? Wealth can, in itself, generate income, and so as wealth inequalities widen, they, in turn, fuel income inequalities. And as wealth is a source of investment, widening inequalities mean a growing gap between rich and poor in their abilities to take advantage of investment opportunities.

More from the OECD: Data on income and wealth can be found at the OECD's Better Life Index (<http://www.oecdbetterlifeindex.org>) and at the OECD Data Portal (<https://data.oecd.org>).

1.2. Measuring inequality: A challenge for data

Inequality can be explored in several ways, all of which give a different sense of how economic resources are spread out across society and even the world. One approach is to look at global wealth

inequalities, which are extreme. For example, Credit Suisse's annual *Wealth Report* reported in 2014 that "that the lower half of the global population collectively own less than 1% of global wealth". By contrast, the bank calculated that the richest 10% owns 87% of global assets, while the top 1% accounts for "almost half of all assets in the world".

Such wealth studies are eye-catching, but they present problems. Not the least of these is that data on wealth is extremely hard to come by, so it's hard to develop reliable figures. That's one reason why inequalities in income have historically been studied more closely.

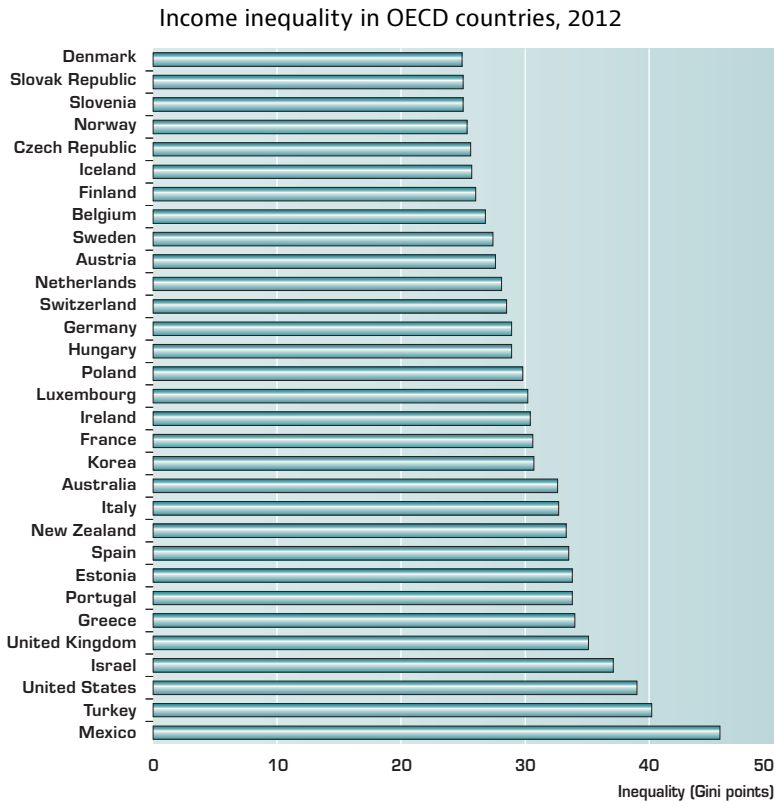
More from the OECD: Wealth inequality generally fell in the middle of the 20th century but has risen in recent years. See "The Distribution of Wealth", (Bonesmo Fredriksen, 2012), an OECD working paper, <http://dx.doi.org/10.1787/5k9h28t0bznr-en>.

Representing inequality

Finding a way to represent inequality using just a single number is challenging, and over the years many approaches have been taken. But the one that's probably best known today is the Gini coefficient, which was defined by the Italian economist and statistician Corrado Gini in the early 20th century.

The basic idea behind the Gini coefficient is straightforward. It uses a value of 0 to represent a society where everyone has the same income and which, therefore, has no inequality; at the other end of the scale, it uses 1 to represent a society where only one person has all the income and which, thus, has maximum inequality. To make them easier to understand, Gini values can also be represented as Gini points. This is done simply by multiplying each value by 100, so a Gini coefficient of 0.28 becomes 28 Gini points. In public debate, a Gini score of 40 points and above is sometimes considered critical.

Data: In the OECD, income inequality varies from around 25 Gini points in some Nordic countries to over 40 Gini points in Turkey and Mexico.



Source: OECD (2015a), *OECD Data Portal*, <https://data.oecd.org/chart/4lz5>.

What are typical Gini values? The average Gini value across OECD countries is 31.5 points, although there is quite a lot of variation between countries. The societies with the lowest levels of inequality, Slovenia and some of the Nordics, score around 24 to 28 Gini points; the most unequal societies, such as Mexico and Chile, score around 45 points.

Discussions of Gini values can revolve around very small changes, perhaps around only one or two points. Can these really matter? It depends. Small fluctuations from one year to the next may reflect issues with data and calculations rather than underlying economic realities. However, small changes that are sustained over time may indeed be significant. “Because the Gini is a sluggish measure, even 1-2 Gini-point increases annually are a big deal,” Branko Milanovic, a World Bank expert on inequality, has written.

Gathering the data

For many reasons, measuring inequality is a challenge. One of the biggest problems lies simply in gathering basic income data. Statisticians use two main sources – tax data and household surveys. Both of these have drawbacks, especially when it comes to estimating the incomes of very low and very high earners.

Household surveys: Better-off people often fail to respond to surveys and, when they do, may not always be willing to reveal their full financial situation; at the other end of the scale, the very poorest people may be so far out on the margins of society that surveys don’t reach them.

Tax data: Information gathered from tax collection gets around some of the problems in household surveys. This is demonstrated by the fact that it tends to report higher earnings among the wealthy than household surveys do. (Indeed, tax data tends to yield far more insights into the situation of top earners rather than low earners.) Still, there are issues. For example, income is often underreported to tax authorities, which may lead to the income of top earners being underestimated. Also, in some countries, people who earn too little to be taxed may not be required to declare their income. And, in most economies, there’s at least some activity in the “shadow” economy, where transactions are paid for in cash and not reported to the tax authorities.

1.3. Measuring poverty: Relative and absolute

Poverty is often thought of narrowly in terms of people's economic resources – a lack of money to buy life's essentials. Indeed many measures of poverty are based around income levels. But poverty is about more than not having money in a purse. It can also be thought of in terms of possessing the basics of life, like shelter or nutritious food; having access to services that improve people's lives, like roads, education and healthcare; being free of the threat of violence; and being able to contribute to decisions that will shape you or your community's future. The impact of these forms of multidimensional poverty is increasingly recognised.

More from Insights: We need to dig behind the headline figures to understand what poverty really means, says the OECD Insights Blog, <http://wp.me/p2v6oD-1MH>.

Absolute poverty

At its most basic, poverty is often discussed in terms of a poverty line – a fixed daily income, such as a dollar a day, or an income below which people cannot afford a basic basket of goods and services. These forms of poverty are referred to as *absolute* poverty. One of the most famous measures of absolute or extreme poverty is indeed the dollar a day. When this level was set by World Bank economists in 1990, it matched closely to the poverty line in many poor countries – in other words, the basic income people needed in order to survive. But the dollar a day was also picked because it was simple and striking: “We intended to have some impact with it,” Martin Ravallion, an economist who was formerly at the World Bank, told the BBC. “Make well-heeled people realise how poor many people in the world are.”

Despite its apparent simplicity, the dollar a day is more complicated than it seems. For one thing, it's not actually a real U.S. dollar but rather a purchasing power parity dollar (PPP\$). This is used because it makes it possible to take account of differing standards of living between countries – in a wealthy country like the United States, a dollar buys very little; in a very poor country, it can

go quite a bit further. The calculations are complicated but, in very basic terms, the PPP\$ represents how much someone would need in a local currency to buy an item costing \$1 in the U.S.

Another complication is that the dollar a day is no longer a dollar. Some years ago, it was revised up to \$1.25 and, in 2015, it was due to be revised again – to around \$1.90. It's difficult to say how this change will affect data on global poverty. According to one set of calculations by World Bank economists, raising the poverty line to \$1.92 would add 148 million to the numbers of people said to be living in extreme poverty.

The dollar-a-day measure is not without its critics. Some argue that the concept is misleading and can create a sense that people living in poverty have a reliable, albeit very small, income. In reality, they argue, people's income can be unpredictable and sporadic – farmers, for instance, may earn all their money just once or twice a year after harvest time. Also, the idea of a subsistence income risks painting an overly simplistic portrait of poor people's lives. As the work of economists Abhijit Banerjee and Esther Duflo has shown, the poor – just like the wealthy – take active decisions on how to spend their incomes, sometimes sacrificing nutrition in order to save for celebrations, for example. Understanding how people make these decisions can be important for the design of national and international aid programmes.

Nevertheless, the idea of measuring absolute poverty in developing countries in terms of a fixed daily income – whether it's \$1, \$1.25 or around \$1.90 – has shown great staying power, especially by helping to anchor the main Millennium Development Goal for poverty reduction.

More from Insights: Attitudes to poverty have changed greatly, explains the OECD Insights Blog, <http://wp.me/p2v6oD-1zo>.

Relative poverty

The concept of dollar-a-day poverty tends to be used in the context of developing – rather than developed – countries. But many rich countries also produce absolute poverty measures, typically

based around the idea of a fixed basket of goods and services that economists estimate are the basic minimum that families need in order to get by. But there's no international agreement on what should be in these baskets, which makes international comparisons of absolute poverty very challenging. That's why for wealthier countries the concept of relative poverty can be more useful. Rather than measuring people's economic situation against a fixed bar, relative poverty gauges where people stand compared to everyone else in their society.

More from the OECD: Poverty has tended to increase in OECD countries in recent years. For the latest numbers, visit the OECD Data Portal, <https://data.oecd.org/>.

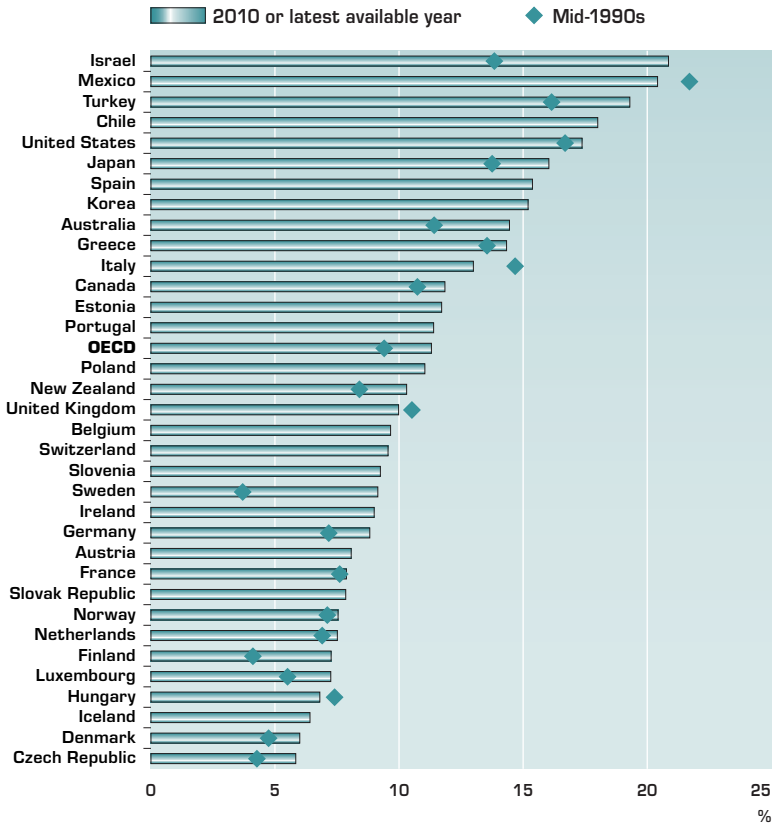
To calculate relative poverty, statisticians fix on a poverty line. There are many ways of setting this line, but here's how the OECD does it: First, statisticians examine the full range of incomes in a country – from lowest to highest– and identify the point that separates the top half of earners from the bottom half. This is the median income. The poverty line is then calculated at 50% of the median income.

Counting the number of people living below the poverty line gives the poverty rate. This figure can be refined still further with a measure called the poverty *gap*, which represents the average income of people living below the poverty line. For example, in both Belgium and the Czech Republic around 9% of people were living below the poverty line in the early 2010s. But in Belgium, their mean income was only around 19% below the poverty line while in the Czech Republic it was around 28%. This means, in effect, that poor people in the Czech Republic were generally poorer than those in Belgium.

As well as these overall measures of poverty, specific measures have also been developed to give a sense of how individual social groups are faring, especially vulnerable groups like children.

Data: Poverty has risen in some OECD countries since the 1980s; around 11% of people in OECD countries live below the poverty line.

Trend in poverty rates in OECD countries since the mid-1980s

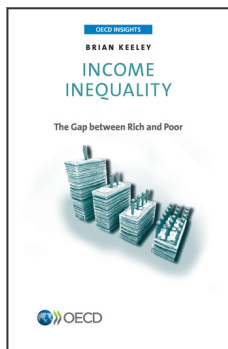


Source: OECD (2014), *OECD Factbook 2014*, <http://dx.doi.org/10.1787/888933025062>.

More from the OECD: Children in OECD countries are more likely to live in poverty than any other social group. Explore the *OECD Family Database*, <http://www.oecd.org/els/soc/oecdfamilydatabase.htm>.

Multidimensional poverty

Increasingly, however, income alone is regarded as an insufficient indicator of poverty and economic inequality, especially in developing countries. People may lack access to education and healthcare, for example, in part because of their individual circumstances, such as gender, ethnicity or place of birth. These deficiencies may greatly reduce people's lifetime opportunities every bit as much as low income, and are far more widespread than traditional measures of poverty might indicate. The United Nations Development Programme calculates that in the 104 countries represented on its Multidimensional Poverty Index (<http://hdr.undp.org>), at least 1.57 billion people are living in multidimensional poverty, representing deprivations in health, education and their standard of living. This is much higher than the roughly 800 million people worldwide estimated to be living in absolute – or \$1.25 a day – poverty.



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