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A note on the relationship between top income shares and the Gini coefficient ☆

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ABSTRACT

When a very top group of the income distribution, infinitesimal in numbers, owns a finite share S of total income, the Gini coefficient G can be approximated by $G^*(1-S)+S$, where G^* is the Gini coefficient for the rest of the population. We provide a simple formal proof for this expression, give a general formula of the relationship when the top group is not infinitesimal, and offer two applications as illustrations.

1. Introduction

In a typical income distribution, the rich may appear insignificant. The most commonly used measure of inequality, the Gini coefficient, is more sensitive to transfers at the center of the distribution than at the tails. In a textbook-sized Lorenz curve, the top 0.1% or even the top 1% are scarcely distinguishable on the horizontal axis from the vertical endpoint. However, changes in top income shares are capable of impacting on changes in overall inequality significantly, as advanced by Atkinson (2007): "If we treat the very top group as infinitesimal in numbers, but with a finite share S of total income, then the Gini coefficient G can be approximated by $G^*(1-S)+S$, where G^* is the Gini coefficient for the rest of the population" (p. 19). The relevance of the last expression has increased with the recent developments of the literature on top incomes (Atkinson and Piketty, 2007, 2010) and the comparison of inequality statistics from survey data and tax records (Burkhauser et al., forthcoming; Leigh, 2007).

The purposes of this note are (i) to provide a simple formal proof of the last statement about the connection between top income shares and the Gini coefficient when the top group is infinitesimal (not given in Atkinson, 2007), (ii) to give a general formula of the relationship when the top group is not infinitesimal, and (iii) to offer two illustrative examples of their application: survey data are usually affected by severe under-reporting at the top, and it is possible to improve the survey-based Gini coefficients by incorporating top income shares estimates coming from other sources (typically tax data).

From a graphical perspective, Atkinson's result is rather intuitive: when the very top group owns a large share of total income S, the Lorenz curve $L(p)$ almost touches the right y-axis at $1-S$. Let us call $L^*(p)$ the Lorenz curve for the non-top group (the bottom 99%, the bottom 99.9%, etc.). Given that $L(p) \simeq L^*(p)(1-S)$, and that the Gini coefficient G (in continuous space) is $1-2\int L(p)dp$, then it is straightforward to note that $G \simeq 1-2\int L^*(p)(1-S)dp \simeq G^*(1-S)+S$. More formally, we start from the decomposition of the Gini coefficient in discrete space proposed by Dagum (1997).

2. The decomposition of the Gini coefficient

Let us consider a population of N individuals with mean income μ, partitioned in $j=1,2,...,k$ non-overlappping subpopulations of N_j individuals with mean income μ_j. Each individual i in group j has income y_{ij}. The Gini coefficient of the whole population is

$$G = \frac{\sum_{j=1}^{k}\sum_{h=1}^{k}\sum_{i=1}^{N_j}\sum_{r=1}^{N_h}|y_{ij}-y_{hr}|}{2N^2\mu}$$

The Gini coefficient *within* the j-th group (simply the Gini of the j-th group) is

$$G_{jj} = \frac{\sum_{i=1}^{N_j}\sum_{r=1}^{N_j}|y_{ji}-y_{jr}|}{2N_j^2\mu_j}$$

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The Gini coefficient *between* the j-th and the h-th groups is (Dagum, 1987)

$$G_{jh} = \frac{\sum_{i=1}^{N_j}\sum_{r=1}^{N_h}|y_{ij}-y_{hr}|}{N_j N_h\left(\mu_j+\mu_h\right)}$$

from which it is straightforward to note that $G_{jh}=G_{hj}$.

Let P_j be the j-th group share in total population

$$P_j = \frac{N_j}{N}$$

and S_j the j-th group income share

$$S_j = \frac{N_j\mu_j}{N\mu}$$

Dagum (1997) has shown that the Gini coefficient for the whole population can be decomposed as follows:

$$G = \sum_{j=1}^{k} G_{jj}P_jS_j + \sum_{j=1}^{k}\sum_{h=1}^{j-1} G_{jh}\left(P_jS_h + P_hS_j\right) = G_\mathrm{w} + G_\mathrm{b} \tag{1}$$

G_w measures the contribution of inequality *within* groups, and G_b measures the contribution of inequality *between* groups.

3. Top income shares

We consider a population partitioned in two ($k=2$). In group $j=1$ we have individuals at the top of the distribution (e.g. the top 0.01%, the top 0.1%, etc.), with income share S and population share P. The rest of the population is in group $j=2$, with income share $1-S$ and population share $1-P$. Then Eq. (1) can be expressed as

$$\begin{aligned} G &= G_{11}PS + G_{22}(1-P)(1-S) + G_{12}P(1-S) + G_{21}(1-P)S \\ &= \underbrace{G_{11}PS + G_{22}(1-P)(1-S)}_{G_\mathrm{w}} + \underbrace{G_{12}(P(1-S) + (1-P)S)}_{G_\mathrm{b}} \end{aligned} \tag{2}$$

In this case (with only 2 subpopulations and with higher-income individuals in $j=1$), G_b can be further simplified:

$$\begin{aligned} G_\mathrm{b} &= G_{12}(P(1-S) + (1-P)S) \\ &= \frac{\sum_{i=1}^{N_1}\sum_{r=1}^{N_2}(y_{1i}-y_{2r})}{N_1N_2(\mu_1+\mu_2)}(P(1-S)+(1-P)S) \\ &= \frac{\mu_1-\mu_2}{\mu_1+\mu_2}(P(1-S)+(1-P)S) \\ &= \frac{\mu_1-\mu_2}{\mu_1+\mu_2}P(1-P)\frac{\mu_1+\mu_2}{\mu} \\ &= (1-P)S-P(1-S) \\ &= S-P \end{aligned} \tag{3}$$

This is equivalent to the result described graphically in Atkinson and Bourguignon (2000), pp. 7–8, for the two-class case. Incorporating Eq. (3) in Eq. (2) and relabeling the Gini coefficients for the non-top and the top groups as G^* and G^{**}, we get the general formula

$$G = G^{**}PS + G^*(1-P)(1-S) + S-P \tag{4}$$

For a very top group, infinitesimal in numbers ($P\to 0$), but with a finite share S of total income, we have

$$\lim_{P\to 0}\left[G^{**}PS + G^*(1-P)(1-S) + S-P\right] = G^*(1-S) + S \tag{5}$$

When the top group is small but not infinitesimal, the general formula given in Eq. (4) can be transformed in a useful way under the assumption that the distribution at the top takes the Pareto form, with Pareto coefficient α, or inverted-Pareto coefficient $\beta=\frac{\alpha}{\alpha-1}$.[1] In this case G^{**} can be easily expressed as a decreasing function of α, or an increasing function of β,[2]

$$G^{**} = \frac{1}{2\alpha-1} = \frac{\beta-1}{\beta+1}$$

and then (4) becomes

$$G = \frac{\beta-1}{\beta+1}PS + G^*(1-P)(1-S) + S-P. \tag{6}$$

Expressions (5) and (6) can be useful empirically: when working with survey data, generally affected by severe under-reporting not only for the top 1%, but also for groups as large as the top 5% or top 10%, it is possible to improve the survey-based Gini coefficients by incorporating top income shares estimates coming from other sources (typically tax data). In the next section we show how both formulas differ in practical cases.

4. Applications

4.1. Case 1: United States

Burkhauser et al. (forthcoming) have tried to reconcile Piketty and Saez's (2003) tax-based top income share series with top income shares from the United States internal CPS. The internal CPS is less affected by top code than the public CPS. They find that their CPS-based top income shares series closely match the Piketty and Saez's series for the top 10–1% (the top decile excluding the top percentile). However, even if the top-code effect is less pervasive, the top 1% measured by the internal CPS is consistently lower than the top 1% measured with tax data.

According to the results in Burkhauser et al. (forthcoming), the internal CPS Gini in the United States increased from 50.3 in 1976 to 58.8 in 2006, the change between those 2 years (net of measurement adjustments in 1992–1993) being 6.2 percentage points.[3] With the formula in (5) we "corrected" G using G^* and the top 1% share from tax data (Table 1). G increased from 52.8 to 64.5 (top share including capital gains) and from 52.3 to 62.3 (top share excluding capital gains) over the same period.[4] If the series including capital gains are taken as benchmark, then the rise in G, 11.7 percentage points, is almost twice as large as the 6.2 percentage points increase recorded by the CPS series. As Atkinson, Piketty and Saez (2009) state, "the top percentile plays a major role in the increase in the Gini over the last three decades and CPS data which do not measure top incomes fail to capture about half of this increase in overall inequality".

Taking the top 1% group as infinitesimal is a rough approximation that can be improved by applying the formula given in Eq. (6). This is done in columns 9 and 10 of Table 1. The Gini coefficients thus obtained are lower, but the increase in G is very similar: 11.8

[1] The average income above a given threshold is β times that threshold. A higher β (lower α) coefficient generally means larger top income shares and higher income inequality.

[2] For a formal proof, see Aitchison and Brown (1954), p. 101.

[3] These values, taken from Burkhauser et al. (forthcoming), Table C1, correspond to the income distribution of tax units (not households), and were chosen for comparability with the unit of analysis of Piketty and Saez (2003).

[4] The results in columns 5–7 of Table 1 are numerically different from those in Atkinson et al. (2009) for two reasons: (i) these authors pinned down G^* for the bottom 99% of the population from Expression (5), while we take it from the direct computations on CPS data from Burkhauser et al. (forthcoming); and (ii) the Gini coefficients in Atkinson et al. (2009) correspond to the household distribution, while we use the tax unit distribution from Burkhauser et al. that is more comparable to the tax-based top income share estimates. The qualitative results are of course the same.