

Chapter 5

Sources of Income Inequality in Nigeria: Decomposition Approaches

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ABSTRACT

Income inequality and poverty in Nigeria are closely related. This chapter analyzes the contributions of income sources and socio-economic factors to income inequality, and estimates the contributions of income redistribution and growth to poverty reduction. Household survey data obtained from the National Bureau of Statistics (NBS) are used. Results show that in 2004, income inequality was higher in rural than in urban areas. Wage and non-farm income made the largest contributions to urban income inequality, while agricultural and wage incomes contributed most to rural inequality. Household size, urbanization, and education significantly increased income inequality, while age, paid/salaried jobs, and non-farm enterprises decreased it ($p < 0.05$). Between 1998 and 2004, income redistribution reduced poverty but income growth increased it. The authors therefore recommend that welfare enhancing programs that benefit the poor should be identified and that better economic opportunities should be created for those in rural areas.

1. INTRODUCTION

The pattern of income distribution has been a concern to economists for a long time (Clarke *et al.*, 2003). Specifically, the 1990s witnessed resurgence in theoretical and empirical attention

by development economists to the distribution of income and wealth (Atkinson and Bourguignon, 2000). This is because high level of income inequality produces an unfavorable environment for economic growth and development. In many developing countries, studies have shown that income

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inequality had risen over the last two decades (Addison and Cornia, 2001; Cornia and Kiiski, 2001; Kanbur and Lustig, 1999). Despite commitments shown by many developing countries towards reducing income inequality and poverty, there is lack of sufficient knowledge of how to design a holistic approach for addressing the issues (Matlon, 1979). The widening dimension of poverty has now aroused serious humanitarian concerns and fears of political instability. It has become evident that in the absence of strong foreign markets, the domestic inter-sectoral linkages and policy environment required for rapid economic growth cannot be provided where inequality and poverty persist (Aigbokhan, 1999; Clarke *et al.*, 2003).

In Nigeria, the rapid economic growth of 1965 to 1974 was accompanied by a serious widening of income disparity. Despite past policy interventions to correct this abnormality, income inequality has increased the dimension of poverty. Aigbokhan (1997, 1999) found that income inequality worsened after the Structural Adjustment Program (SAP) of 1996. Similarly, poverty incidences were 28.1, 46.3, and 65.6 percent in 1980, 1985 and 1996, respectively (World Bank, 1996; IMF, 2005). Also, a high level of income inequality exists between Nigeria's rural and urban areas. This is because most rural communities depend on agriculture while urban areas have more diversified economies and offer mostly paid jobs. Income inequality leads to discontent, violence, and corruption and, as part of macroeconomic objectives, governments therefore make equitable income distribution a priority. This is important because income inequality is closely related to poverty (Addison and Cornia, 2001; Adams, 1999; Adams and He, 1995; Aboyade, 1983), and a careful study of inequality provides insights into the incidence of poverty.

Studies on decomposition of income inequality are desirable for both arithmetic and analytic reasons (Litchfield, 1999). Policy makers may wish

to determine the contributions by socio-economic characteristics to total income inequality. This sheds light on the structure and dynamics of income within different socio-economic groups in the economy. Also, the importance of various income sources to total income and income inequality is vital for evaluating the impact of a given income source (agricultural or non-farm employment for instance) on total income inequality. This information helps to understand the effect that changes in household labor force participation can have on income distribution (Fournier, 1999). Recent advances in the understanding of the linkage between poverty and income inequality make it possible to determine the contributions of income redistribution and income growth to poverty change within a period of time. This information is very helpful to economic policy analysts and designers of poverty reduction programs.

This chapter has four objectives. The first is to provide a descriptive analysis of households' income from different sources and determine the level of income inequality. The second is to decompose the contributions of the income sources to overall income inequality and find the within-between contributions. The third is to determine the contributions of select household socio-economic characteristics to income inequality. The fourth is to analyze the contributions of income growth and income redistribution to poverty change. Objectives one, two and four were extensively analyzed by Duclos *et al.* (2005). Two hypotheses were tested. The first is that there is no significant difference between income received from different sources, while the second is that attainment of formal education does not significantly increase households' per capita incomes. The remaining parts of the chapter contain the conceptual framework and literature review, materials and methods, results and discussions, and policy implications and conclusion.

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