

## The Determinants of Gini Coefficient in Iran Based on Bayesian Model Averaging

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**Abstract:** *This paper has tried to apply BMA approach in order to investigate important influential variables on Gini coefficient in Iran over the period 1976-2010. The results indicate that the GDP growth is the most important variable affecting the Gini coefficient and has a positive influence on it. Also the second and third effective variables on Gini coefficient are respectively the ratio of government current expenditure to GDP and the ratio of oil revenue to GDP which lead to an increase in inequality. This result is corresponding with rentier state theory in Iran economy. Injection of massive oil revenue to Iran's economy and its high share of the state budget leads to inefficient government spending and an increase in rent-seeking activities in the country. Economic growth is possibly a result of oil revenue in Iran economy which has caused inequality in distribution of income.*

**Keywords:** Gini coefficient, Bayesian Model Averaging (BMA).

**JEL classifications:** H53, C01, I38

### 1. Introduction

The economic theories on the income distribution entails a vast array of potential factors by which income inequality can be influenced, with little guidance on selection of appropriate variables to include in Gini coefficient regression. The lack of an accepted empirical specification for use in Gini coefficient regression thus generates uncertainty regarding, for example, which explanatory variables must be included in the model, which functional forms are appropriate, or which lag length captures dynamic responses. In econometrics, all these problems are known as problems of model uncertainty (De luca and Magnus, 2011).

Much of the lengthy econometric literature on the subject of model selection is to do estimate large, flexible models and then performing sequence of tests and various restrictions to find a single best model which has all the irrelevant variables omitted (Koop, 2003). Estimating highly flexible models is far from a solution to addressing model uncertainty (e.g. Danilov and Magnus, 2004). It raises concerns about “overfitting” to arrive at specifications overly sensitive to the particular characteristics of the data sample. The ability to discriminate among competing theories of inequality is further hampered by the collinearity among many of the variables of theoretical interest. For these reasons, it is widely accepted that econometric model building should proceed from and be guided foremost by theoretical considerations (Hopkins, 2004). Therefore drawing proper inference requires formal recognition of this uncertainty in the search for model specification. Bayesian model averaging (BMA) techniques provide a coherent method of inference on the regression parameters of Gini coefficient by taking explicit account of the uncertainty due to both the estimation and the model selection steps (De luca and Magnus, 2011).

This paper sets out a BMA approach to assess how macroeconomic factors affect the Gini coefficient in Iran during 1976-2010. Section 2 presents a brief review of theoretical and empirical literature on income distribution. We also present the empirical results of the paper in section 3, and section 4 concludes.

## 2. Theoretical Literature

The primary studies concerning determinants of income inequality investigate the effect of economic growth on income inequality. Argument in this field is started by Kuznets's investigation. Kuznets (1955) found an inverted-U shape between per capita income and inequality based on a cross-section of countries: as countries developed, income inequality first increased, peaked, and then decreased. The major driving force was presumed to be structural change that occurred because of labor shifts from a poor and less productive traditional sector to a more productive and differentiated modern sector. Following Kuznets's study, investigation of 60s and 70s were conducted to test Kuznets's inverted-U hypothesis based on cross-section of countries. These studies were confirmed Kuznets's hypothesis (e.g. Kravis, 1960; Oshima, 1962; Paukert, 1973). But further studies have tested on individual countries challenged Kuznets's inverted-U hypothesis and evaporated it (e.g. Anand and Kanbor, 1993; Fields, 1989; Deininger and Squire, 1997).

Many studies have been done on other influential factors in Income distribution, including inflation, unemployment, investment, education, government expenditures, taxation, financial development, trade openness and et cetera. In the following we refer to a number of these studies.

Table 1: Empirical Studies

The Researcher(s)	Sample	Dependent Variable	Explanatory Variables	The Results
Shultz (1969)	USA (1944-65)	Gini coefficient	Unemployment rate, wholesale price, real GDP growth, trend	This study shows that the unemployment is the most important variable affecting the Gini coefficient and other variables have less importance.
Gustafsson & Johansson (1997)	16 members of OECD countries (1966-94)	Gini coefficient	Unemployment rate, inflation, GDP per capita, import from LCD, public sector	The Paper suggest that many factors affect the development of inequality. Factors are strictly economic or outside a strictly defined market-sphere as well as being demographic. However, a relation between the unemployment rate and inequality could not be found.
Seral (1997)	Cross-section of 45 countries (different years)	Gini coefficient	Income per capita, terms of trade, exchange rate, inflation, investment, public consumption, external position	The paper indicates that growth rate, Income level, Investment rate, Improvement and terms of trade have negative effect on changes in Gini coefficient. Also other variables have no significant effect on independent variable.
Jantti and Jenkins (2001)	United Kingdom (1961-91)	Quintile group income shares	employment rate, inflation rate, real interest rate, GDP growth rate	This paper indicate that when GDP growth rate is added to the regressor, the results alter. Inflation remains statistically insignificant, but the unemployment rate, the real interest rate and the GDP growth are statistically significant.
Abounoori (2003)	Cross-section of 96 developed and developing countries (different years)	Quintile group income shares	Unemployment, inflation, dummy variable for developed/developing countries	In this paper Inflation is found to have an increasing impact on the shares of lower 80% of the income distribution, while reducing the share of the highest 20%. Unemployment has a negative effect on the share of the first 40%, while increases the share of the highest 60%.
Østergaard (2013)	41 Sub-Saharan African countries (1980-2010)	Gini coefficient	Series of economic, demographic and political factor	This study indicate that important factors in making income distribution more equal include the level of education, the degree of government expenditure, and the existence of

				democracy. The Kuznets inverted U-relationship is not supported by the data.
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### 3. Data and Empirical Results

In both theoretical and empirical studies, many different kinds of variables have been considered as significant determinants of Gini coefficient. So in this research, by application of the method of Bayesian Model Averaging (BMA), the effects of influential factors on Gini coefficient which have been regarded in previous studies are investigated. We use Stata program to obtain the coefficient of BMA estimates.

#### 3.1. Data

The variables used in the model are from time series data between 1976-2010. All of the data is obtained from Central Bank of Iran (CBI). The variables are regarded based on growth rate and ratio, though all the variables are stationary. Each of variable of model has been presented briefly in Table (2). In advance we concisely explain about some variables of this model.

- The dependent variable is Gini coefficient. Therefore we investigate influential variables on it. The Gini coefficient is the most frequently used indicator of inequality. It is defined as a ratio with values between zero and one in which zero means perfect quality and one means complete inequality.
- The primary studies concerning determinants of income distribution investigate the effect of income level on income inequality. So we use real GDP growth as one of explanatory variable. Also to determine whether income inequality is square root related with economic growth or not, the square of real GDP growth rate is used to examine it.
- Regarding the dependency of Iran to revenue of exported oil and influence of oil revenue on most macroeconomic variables, we consider the ratio of oil revenue to GDP in model.
- Due to importance of education role on income distribution, we use two variables of literacy rate and ratio of the number of public high school student to population (Human capital index) in model.
- One of the subjects discussed in redistribution of incomes is presence of government and its expenditure in economy. Here we include three variables of the ratio of government current expenditure to GDP, the ratio of education department to GDP and the ratio of hygiene and treatment expenditure to GDP in the model in order to investigate their effects on Gini coefficient.
- There are two viewpoints about the relationship between financial development and income distribution. The first viewpoint is argued by Greenwood and Jovanovic (1990), is considered inverse U-shaped relationship between financial development and income inequality. In contrast to the Greenwood-Jovanovic theory, the second viewpoint is assumed a negative linear relationship between these two variables (Banerjee and Newman, 1993; Galor and Zeira, 1993). Accordingly we consider the ratio of  $M_2$  (broad money) to GDP and its square as explanatory variables in model to examine these theories.
- Regarding tax role in government redistribution policy, growth rate of direct taxes, growth rate of direct taxes and the ratio of total tax to GDP are included in the model.

- We use dummy variable in the model in order to consider the effect of war (1980-1988) on income distribution. This dummy variable adopts one for war years and zero for other years.

Table 2: List of model's variables

Variable type	Variable name	Variable symbol
Dependent variable	Gini coefficient	gini
Explanatory variable	Constant term	constant
	GDP growth rate	grgdp
	The square of GDP growth rate	grgdp2
	Ratio of oil revenue to GDP	rtoigdp
	Inflation rate	inf
	Unemployment rate	ur
	Literacy rate	litert
	Ratio of the number of public high school students to population	rtstupop
	Ratio of government current expenditure to GDP	rtgovgdp
	Ratio of education department to GDP	rtedugdp
	Ratio of hygiene and treatment expenditure to GDP	rthyggdp
	M <sub>2</sub> to GDP ratio	m2gdp
	The square of M <sub>2</sub> to GDP ratio	m2gdp2
	Growth rate of direct taxes	gtaxdi
	Growth rate of indirect taxes	gtaxindi
	Ratio of total tax to GDP	rttaxgdp
	Growth rate of exchange rate	gexr
	The share of exports plus imports to GDP	rteximgdp
	Dummy variable	dum

### 3.2. Empirical Results Based on BMA

One of the most important privileges about BMA analyzing is the high level of trust in coefficients estimated in explanatory variables. Because these coefficients are not estimated based on just one model but they are derived from averaging model of estimated coefficients in every single variable with 262144 (=2<sup>18</sup>) recapitulations or effective samplings. The coefficient for each of BMA estimates is calculated in this way:

$$\hat{\beta}_1 = \sum_{i=1}^I \lambda_i \hat{\beta}_{1i}$$

$\lambda_i$  is the possibility of "i" numbers of model and  $\hat{\beta}_{1i}$  is an estimation of  $\beta_1$  which is gained in case of  $M_i$  model being. Table (3) shows the t-ratio and the posterior inclusion probability (pip) for each of the BMA estimates which shed some light on the relative importance of each regressor. Now we are going to analyze regarding to the results of table (3):

Table 3: The results of BMA estimation

Variable	Coefficient	t-ratio	pip
Constant	0.3720	6.19	1.00
GDP growth rate	0.1312	2.03	0.90
The square of GDP growth rate	-0.1202	-0.40	0.20
Ratio of oil revenue to GDP	0.1195	0.85	0.53
Inflation rate	0.0032	0.23	0.11
Unemployment rate	0.0007	0.46	0.23
Literacy rate	-0.0283	-0.67	0.40
Ratio of the Number of public high school students to population	-0.0738	-0.28	0.20
Ratio of government current expenditure to GDP	0.2092	1.25	0.68
Ratio of education department to GDP	-0.0215	-0.25	0.11
Ratio of hygiene and treatment expenditure to GDP	-0.5765	-0.54	0.31
M2 to GDP ratio	0.0037	0.08	0.13
The square of M2 to GDP ratio	0.0060	0.17	0.13
Growth rate of direct taxes	-0.0060	-0.54	0.29
Growth rate of indirect taxes	-0.0007	-0.25	0.11
Ratio of total tax to GDP	-0.0116	-0.12	0.11
Growth rate of exchange rate	0.0014	0.22	0.10
The share of exports plus imports to GDP	0.0042	0.29	0.13
Dummy variable	0.0002	0.34	0.17

As a rough guideline for “robustness” of a regressor, a value  $pip = 0.5$  is sometimes recommended (Raftery, 1995), corresponding approximately with an absolute t-ratio of  $|t| = 1$  (Masanjala and Papageorgiou, 2008). Regarding  $pip \geq 0.5$  for robustness of a regressor, the results of the table (3) may be explained as follows:

- We see that GDP growth rate is by far the most robust auxiliary regressor with  $pip = 0.90$ . It has a positive impact on Gini coefficient. The coefficient of this variable has been obtained 0.13 which indicates that averagely for each percent increase in the economic growth, % 0.13 will be added to the Gini coefficient. Therefore the nature of economic growth in Iran is inclined to more inequality. As a matter of fact, economic growth of Iran is generally in conjunction with oil revenue increase or price perform and liberalization policies which worsen the distribution of income.
- The second effective variable on Gini coefficient is the ratio of government current expenditure to GDP with  $pip = 0.68$ . The coefficient of this variable is positive which means an increase in this ratio results in higher degree of inequality. This is probably due to more extensive use of government services by high-income groups of people whereas low-income groups have less chance of using government service. In fact, welfare policies and social spending of government for supporting vulnerable groups has not been efficient.
- The ratio of oil revenue to GDP is the third important auxiliary regressor with  $pip = 0.53$  and it has a positive impact on Gini coefficient. Considering economic condition of Iran, oil revenue has an impact on GDP, economic structure and providing the state budget. This result is corresponding with rentier state theory<sup>1</sup> in Iran economy. So that interest groups try to possess greater share of oil rents by penetrating into budgeting

<sup>1</sup>In political science and international relations theory, a rentier state is a state which derives all or a substantial portion of its national revenues from the rent of indigenous resources to external clients. This theory was first postulated Mahdavy in 1970.

and financial resource allocation. Accordingly it seems oil revenue increase has expanded higher opportunities of rent-seeking and corruption in Iran economy. Besides competitive ability of national products has decreased with increase in availability of foreign exchange resources and more imports of consumption goods and ground is prepared for non-productive and speculative activities and income gap increasing.

- Other considered variables have not strong correlation with Gini coefficient with pip less than 0.5. In fact it seems the other variables have affected the economic inequality from main variables of economic growth, government current expenditure and oil revenue so that after controlling the above variables they have no important effect on Gini coefficient.

### 3.3. Selection of Optimum Models

"STATA" program present vselect command in order to select variables after performing a linear regression. This command determine the best subsets of each predictor size by using leaps-and-bounds algorithm and provides the five information criteria<sup>2</sup> for each of these models in order to select the optimum model. The optimal model is the one model with these qualities: the smallest value of Akaike's information criterion (AIC), Akaike's corrected information criterion (AICc) and Bayesian information criterion (BIC); the largest value of  $R^2_{ADJ}$  (adjusted); and a value of Mallows's  $C_p$  that is close to the number of predictors in the models +1 or the smallest among the other Mallows's  $C_p$  values. These guidelines help avoid the controversy of which information criterion is the best. Sometimes there is no single model that optimizes all the criteria. There are no fixed guidelines for this situation. Generally, we can narrow the choices down to a few models that are close in optimization (Lindsey and Sheather, 2010). Then we make an arbitrary choice among them. We see the results of vselect command in Table (4):

Table (4): The results of vselect command  
Optimal Models Highlighted

Preds	R2ADJ	C	AIC	AICC	BIC
1	.6112954	33.30965	-183.156	-88.67847	-180.163
2	.7417969	13.055	-195.7375	-100.659	-191.248
3	.7781721	8.265046	-199.8671	-103.9949	-193.8811
4	.803071	5.512912	-202.9541	-106.0733	-195.4715
5	.8276937	3.056856	-206.562	<u>-108.432</u>	<u>-197.5829</u>
6	.833581	3.374332	-206.9547	-107.3047	-196.4791
7	.8465719	<u>2.834394</u>	-208.9311	-107.455	-196.959
8	.850569	3.544957	-209.1493	-105.4994	-195.6807
9	<u>.8567865</u>	4.032786	<u>-209.9562</u>	-103.7348	-194.9911
10	.8573041	5.233345	-209.5426	-100.2927	-193.081
11	.8552178	6.722027	-208.5988	-95.79093	-190.6407
12	.8543642	8.061635	-208.0149	-91.03159	-188.5603
13	.8536042	9.383222	-207.5358	-85.65054	-186.5847
14	.8464512	11.292	-205.7457	-78.0958	-183.2981

<sup>2</sup>An information criterion is a function of a regression model's explanatory power and complexity. The model's explanatory power (goodness of fit) increases the criterion in the desirable direction, while the complexity of the model counterbalances the explanatory power and moves the criterion in the undesirable direction (Sheather, 2009).

15	.8389738	13.15531	-204.0629	-69.61293	-180.1188
16	.8301197	15.0552	-202.2971	-59.79001	-176.8565
17	.8194576	17.00375	-200.4181	-48.30662	-173.481
18	.8066135	19	-198.4269	-34.777	-169.9933

## Selected Predictors

- 1: rtoigdp
- 2: grgdp rtgovgdp
- 3: grgdp rtgovgdp litert
- 4: grgdp rtgovgdp grgdp2 litert
- 5: grgdp rthyggdp rtoigdp gtaxdi litert
- 6: grgdp rteximgdp rthyggdp rtoigdp dum gtaxdi
- 7: grgdp rthyggdp gexr ur rtoigdp gtaxdi rtstupop
- 8: grgdp rthyggdp gexr ur rtoigdp gtaxdi inf rtstupop
- 9: grgdp rteximgdp rthyggdp gexr ur rtoigdp dum gtaxdi m2gdp2
- 10: grgdp rteximgdp rthyggdp gexr ur rtoigdp dum gtaxdi m2gdp2 gtaxindi
- 11: grgdp rteximgdp rthyggdp gexr ur rtoigdp dum gtaxdi inf m2gdp2 gtaxindi
- 12: grgdp rteximgdp rthyggdp gexr ur rtoigdp dum gtaxdi rtgovgdp grgdp2 inf rrtaxgdp
- 13: grgdp rteximgdp rthyggdp gexr ur rtoigdp dum gtaxdi rtgovgdp grgdp2 inf rrtaxgdp rtedugdp
- 14: grgdp rteximgdp rthyggdp gexr ur rtoigdp dum gtaxdi rtgovgdp grgdp2 inf rrtaxgdp rtedugdp m2gdp2
- 15: grgdp rteximgdp rthyggdp gexr ur rtoigdp dum gtaxdi rtgovgdp grgdp2 inf rrtaxgdp rtedugdp m2gdp2 gtaxindi
- 16: grgdp rteximgdp rthyggdp gexr ur rtoigdp dum gtaxdi rtgovgdp grgdp2 inf rrtaxgdp rtedugdp litert m2gdp2 gtaxindi
- 17: grgdp rteximgdp rthyggdp gexr ur rtoigdp dum gtaxdi rtgovgdp grgdp2 inf rrtaxgdp rtedugdp litert m2gdp2 gtaxindi m2gdp
- 18: grgdp rteximgdp rthyggdp gexr ur rtoigdp dum gtaxdi rtgovgdp grgdp2 inf rrtaxgdp rtedugdp litert m2gdp2 gtaxindi m2gdp rtstupop

Invoking  $vselect$  on the data, we find that  $R^2_{ADJ}$  and AIC both select the nine-predictor model. Mallows's  $C_p$  advocates the eighteen-predictor model when we choose a model with  $C_p$  close to the number of predictors +1. Otherwise, when choosing the smallest  $C_p$  value, we will choose the seven-predictor model. The level of difference for each criterion from the AIC-chosen predictor size to its own chosen size is minimal. So we choose the seven-predictor model. The optimal model on AICc and BIC is the five-predictor model.

#### 4. Conclusion

The economic theories on the income distribution entails a vast array of potential factors by which income inequality can be influenced, with little guidance on selection of appropriate variables to include in Gini coefficient regression. Besides there is not a generally accepted empirical specification for use in Gini coefficient regressions. To solve this problem, we applied Bayesian Model Averaging (BMA) approach in order to analyze the impact of 18 macroeconomic factors on Gini coefficient in Iran based on annual data from 1976 to 2010.

The results indicate that the GDP growth rate is the most robust auxiliary regressor affecting the Gini coefficient, leading to more inequality. Economic growth is out of favor with low income groups. Thus economic growth policy needs to be revised fundamentally. The second influential factor on Gini coefficient is the ratio of government current expenditure to GDP. The coefficient of this variable is positive which means an increase in this ratio and government intervention worsens the distribution of income. Therefore transfer payments and government expenditure not only failed to achieve one of its rudimentary goals, but also caused more inequality. Also it seems the expenditure is the origin of distribution of rents and corruption and way of its distribution among different groups causes more inequality. The third influential variable on Gini coefficient is the share of oil revenue to GDP which worsens distribution of income. The effect of this variable can happen directly by means of spreading rent-seeking activities or indirectly by means of an increase in imports of consumption goods and decrease of competitive ability of domestic products, reduction of protectionism and the expansion of speculative activity. Other considered variables have not strong correlation with Gini coefficient specially the ratio of  $M_2$  to GDP and its square. So this is inconsistent with Greenwood-Jovanovich theory which assumes inverse U-shaped relationship between financial development and income inequality. Moreover the square of  $M_2$  to GDP coefficient is positive which contrasts to this theory.

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