BOX 1.3

International comparisons of living standards—the need for purchasing power parities

To compare the incomes of people in different countries, the incomes must first be converted into a common currency. Until 1999 the *Human Development Report* used income measures based on exchange rate conversions in assessing global income inequality (as in the comparison of income for the richest 20% and the poorest 20% in the world). But exchange rate conversions do not take into account price differences between countries, which is vital when comparing living standards. To take account of these price differences, purchasing power parity (PPP) conversion rates are used to convert incomes into a common currency in which differences in national price levels have been eliminated.

The two approaches to measuring inequality produce very different results. Using exchange rates not only produces much higher measures of inequality, but also affects trends in inequality.

With the exchange rate measure, the ratio of the income of the richest 20% to that of the poorest 20% grew from 34 to 1 in 1970 to 70 to 1 in 1997. With the PPP measure, the ratio fell, from 15 to 1 to 13 to 1. Although both measures show increasing inequality between the richest 10% and poorest 10%, the exchange rate measure shows a much larger increase than the rise in real living standards.

While PPPs are the best way to convert income when comparing living standards, they are not without theoretical and practical problems. These problems point to the need for greater support—financial and institutional—for the collection of PPP data.

Income inequality between the world's richest and poorest, based on country averages, 1970 and 1997

	Richest 10% to poorest 10%		Richest 20% to poorest 20%	
Measure	1970	1997	1970	1997
Exchange rate	51.5	127.7	33.7	70.4
Purchasing power parity	19.4	26.9	14.9	13.1

Source: UN 2000b; Melchior, Telle and Wiig 2000; Human Development Report Office calculations based on World Bank 2001h and 2001g.