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China’s Inequality is Important – but which Inequality?

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Abstract: This think-piece questions the normative value in the Chinese case of standard measures of aggregate income inequality such as the Gini coefficient. Evidence is adduced that people have narrow frames of reference and that they distinguish between income inequalities that they perceive to be fair and those that they perceive to be unfair. It is suggested that value judgements about what is fair or unfair can be guided by people’s own perceptions. People’s perceptions of unfairness can also be important to a government concerned to avoid social instability. The estimation of happiness functions can help to make the relevant distinctions. Examples are given of how fair and unfair inequalities might be identified. Unfairness might be more strongly perceived and felt in inequalities of economic power than in inequalities of income, although the former can in turn result in inequalities of income. An argument is made for China researchers to extend inequality research and research instruments towards an economics of fairness and unfairness.

Key words: Fairness; Frames of reference; Gini coefficient; Inequality of income; Inequality of economic power; Unfairness

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1. Introduction

China’s income inequality is normally measured with the Gini coefficient. The Gini has the advantages that it can be easily measured using national microeconomic sample surveys, inequality is reduced to a single number, and its common use - in China, over time, and in other countries - means that easy comparisons can be made.

For instance, the China Household Income Project (CHIP) surveys have been available to estimate the Gini coefficient of household per capita income among households, and the estimates have been used to track inequality in China over time. Comparing the three most recent CHIP surveys of 2002, 2007 and 2013, the comparable Gini estimates were 0.46 in 2002, 0.49 in 2007, and 0.45 in 2013. Thus some year between 2007 and 2013 can be seen as the turning point between rising and falling income inequality in China (shown in Table 1).

A division into urban and rural China adds complexity to this story (also shown in Table 1). Between 2002 and 2007 the ratio of urban to rural household income per capita (already above 3.0) rose further. There is a similar rise in the ppp-adjusted figure, which reduces the ratio in both years. This rise was the main reason for the growth of the national Gini: the urban Gini rose a little and the rural Gini not at all. Between 2007 and 2013 the urban-rural income ratio fell sharply, to well below 3.0 in the nominal case. By contrast, the Gini rose in urban and in rural areas, and in both cases by more than it had done between 2002 and 2007. We see the importance of the urban-rural income ratio in determining China’s degree of income inequality and its change. These estimates will be evaluated below.

Depending on the value of the Gini coefficient, China’s income inequality can be considered as either ‘too low’ or ‘too
high’. One criterion is efficiency and another is equity, i.e. fairness. In 1988 (the year of the first CHIP survey) the national Gini (at 0.38) was low for such a large and diverse country and the urban Gini (at 0.23) was particularly low (Khan et al., 1993). There was a general perception among reforming policy makers that inequality was too low for the efficient operation of a marketising economy: incentives were needed and these would necessarily create inequalities among people. However, in the 21st century there was a widespread view in China that inequality was now too high. Much of the inequality was not required for efficiency and could not be justified in terms of equity.

The notion of equity might simply be based by economists and policy makers on a straightforward value judgement that, for instance, the Gini coefficient is too high. However, it is worth delving deeper and considering the basis for such a value judgement. Peoples’ perceptions are potentially relevant. How much concern is there about income inequality in China?

2. Inequality of Income

A sociological survey conducted in 2004 examined Chinese people’s attitudes to the degree of inequality and what inequality they regarded as fair (Whyte, 2010). It was found that Chinese people were not averse to inequality based on merit, effort, or risk-taking. Indeed, such inequality appeared to offer people incentives or other opportunities for improving their economic positions. By contrast, inequality based on unfairness in treatment or in access to opportunities was generally disliked. Whyte (2010) found that farmers, despite being the poorest group, were the least discontented. Actual income is not necessarily a good guide to perceived distributional injustice because people’s information sets and aspirations not only matter but also vary.
Happiness research might assist in formulating value judgements on inequality. Easterlin et al. (2014) found evidence of a marked increase over two decades (1990-2010) in inequality not only of income but also of life satisfaction scores. The value judgement might be made that inequality of life satisfaction or happiness should be an important criterion in social evaluation. Recent CHIP surveys, and in particular the CHIP 2002 survey which contained a questionnaire module on happiness, permit the estimation of happiness functions in order to examine the determinants of happiness or life satisfaction. We concentrate on the variables denoting absolute and relative income.

Table 2 shows the coefficients in happiness functions (with reported happiness cardinalised so that very happy = 4, happy = 3, so-so = 2, not happy = 1, and not at all happy = 0). The first column reports the coefficient on ln household income per capita. It shows that happiness rises with income level: inequality of income does indeed create inequality of happiness. However, the effect is small: in the rural case a doubling of (instrumented) income raises the happiness score by only 0.40 and in the equivalent urban case by a similar amount.

By contrast, the table shows that in the rural sample there is a great difference in conditional happiness score (1.05) between those who report themselves to be well above the village average in living standard and those who report to be well below. The importance of inequality within the village is confirmed by the facts that two thirds of the respondents claimed to compare themselves with persons within the village and very few reported having a national or even a province-wide reference group. Similarly the difference in conditional happiness score between urban residents in the first quarter
of the income distribution of their city and the fourth quarter is 0.81.

It is possible to distinguish relative income effects from absolute income effects because of the great differences in village mean income across villages and in city mean incomes across cities in the survey. In both rural and urban China we see the importance to happiness of a household’s rank in the local income distribution: local income rank generates considerable inequality of happiness. The narrowness of reference groups suggests the case for adopting policies which aim to reduce local income inequalities.

The same study (Knight and Gunatilaka, 2010) produced an unexpected result that raises an ethical question. Although the ratio of urban to rural household income per capita was then 3.1 to 1, the mean happiness score of rural residents was 2.7 (on the scale ranging from 4 to 0) and that of urban residents was 2.5. A decomposition analysis showed that the higher happiness of rural people was not due to superior characteristics but to their superior happiness-generating function. They had limited information sets and narrow reference groups, their income had risen in recent years and they expected it to rise in the future, and they placed a high value on personal and community relationships. The nature of urban society that had emerged including high but unfulfilled aspirations and feelings of insecurity made for unhappiness of urban dwellers despite their relatively high incomes.

The inferior institutional and policy treatment of rural-dwellers, much documented (for instance by Knight and Song, 1999), is generally perceived to be unfair. It has its origins in China’s history. For instance, during the period of central planning, the official policy was that rural areas were expected to support themselves and that the price-scissors policy should extract a rural surplus so as to pay for urban
industrialisation. After rural reform, rural people benefited from higher farm incomes, rural industrialisation, and opportunities for temporary rural-urban migration. Nevertheless, discrimination continued. This might be explained by lack of discontent and absence of political threat within the rural population. We saw that farmers were the least discontented group in Whyte’s survey of 2004 and that, according to the CHIP survey of 2002, rural people reported themselves to be happier on average than urban people. Any expressions of rural discontent would be localised, uncoordinated, and little publicised.

Can the unfair treatment of rural residents be justified by the evidence that they had higher happiness scores, on average, than urban residents? This question suggests the limitations of basing normative judgements on happiness alone. Although it may be accepted that advancement in subjective well-being is valuable, it may also be accepted that policies to raise happiness should be conditioned on fairness in the state’s treatment of rural-dwellers in relation to urban-dwellers.

It is notable in Table 1 that the national Gini coefficient fell between 2007 and 2013 because of the fall in the urban-rural income per capita ratio and despite the rise in the Gini within both urban and rural China. These facts raise another ethical question. How much weight should be placed on a fall in the Gini coefficient that is due to a narrowing of urban and rural incomes if it is the case that people’s reference groups are sufficiently local that the urban-rural income gap does not influence happiness? If happiness is the criterion it may be more important to look instead within urban and within rural China and indeed even more narrowly than that.

It is difficult to distinguish specific sources and forms of inequality in household income per capita that are likely to
be regarded as fair and those that are likely to be regarded as unfair. More progress might be made in the case of the wages of individuals. Knight and Song (2005:56) decomposed labour earnings inequality by the determinants of earnings using the 1988 and 1995 CHIP surveys.

Human capital (both education and occupation-based skills) made a growing contribution to earnings inequality as labour market forces strengthened. These productive characteristics might be regarded as efficiency-enhancing and fair, although this view might be tempered if unequal access to opportunities for education and training is regarded as unfair. Over the same period minor contributions to earnings inequality were made by the ‘discrimination’ variables, gender, CCP membership, and minority status; unless they can be justified by efficiency differences, these might appear to be unfair. The ‘segmentation’ variables, ownership form and province, both contributed to earning inequality and its rise. In particular, people might feel that the growing earnings differences between the more and less prosperous provinces are unfair if their happiness is sensitive to these differences.

A distinction can be made between monopoly industries and competitive industries. Yue et al. (2011) defined China’s monopoly industries as those with high concentration, restrictions on entry and exit, and regulated prices (they happened also to be largely state-owned or state-controlled) and competitive industries as those which approached conditions of perfect competition. Wage equations were estimated using productive, personal and regional variables, and a decomposition analysis was conducted. It found that less than half of the wage difference (the wage ratio being 1.45 in favour of monopoly industries) was explained by differences in characteristics, and that the remaining difference could be the result of monopoly power, which is subject to government
policy. That wage difference might be perceived as conferring an unfair advantage on some workers.

3. Inequality of Economic Power

Whyte (2016), reporting on a 2014 follow-up to the 2004 survey, found no increase in dissatisfaction with income inequality or its rise. From his limited (because politically sensitive) evidence about power relations in society, he discerned that there was greater social discontent with inequality of power than with inequality of income. Inequality of power led to unaccountable abuse of power, such as official corruption, bureaucratic failures to protect the public from harm such as environmental degradation, and procedural injustices such as mistreatment by those in authority and inability of those mistreated to obtain redress. The two forms of inequality did interact because the powerful could use their power for income gain, but discontent was directed more at inequality of power than of income.

China’s government worries about ‘social instability’ and has often publicly expressed its concern to maintain social stability. Social instability is seen as a threat both to the political order and to the continued rapid growth of the economy. It is arguable that such concern has moulded economic policy-making. The reform leadership’s economic policy was essentially to accord overriding priority to the achievement and maintenance of rapid economic growth. Rapid growth was viewed as the best way to secure political legitimacy and to avoid social instability. Rapid growth of income itself raised life satisfaction. However, the remarkable transformation of China’s economy and society that rapid growth entailed posed new threats to people’s life satisfaction. It is relevant that despite China’s remarkably rapid growth average life satisfaction did not rise over two decades (Easterlin et al., 2012).
Given the difficulty of examining social discontent more directly, it is worth approaching this issue through the study of happiness (Knight and Gunatilaka, 2013, Knight, 2014b). Microeconomic analysis suggests that unhappiness — and by implication social instability — is sensitive not only to economic inequality and expectations about future income growth but also to perceptions of corruption and of procedural injustice. The leadership ignored rising inequality for the first 25 years of economic reform but in the last decade government has addressed the issue of high income inequality with its Harmonious Society policies — which concentrated on the bottom end of the income distribution rather than the top.

It is possible that those who are personally happy will be socially discontented, and that people who are personally unhappy will not be socially discontented. Unhappiness does not necessarily translate into the expression, or even the feeling, of discontent. It may require a perception that their unhappiness is man-made and remedial by government for unhappy people to express their discontent. The nature of the sources of unhappiness is therefore potentially relevant. This might be the explanation for the finding in Whyte (2016) that his survey respondents were more concerned about inequality of power than inequality of income. Whereas the influence of the state and officialdom on income inequality in itself may not be obvious and direct, their influence on people’s lives through the exercise of power can be more directly perceived.

China faces a serious principal-agent problem that arises because political control is centralised but economic management is decentralised. The leadership established an incentive structure which ensured that cadres pursued the leaders’ objectives, primary among them being the achievement of rapid economic growth (Knight, 2014). However, it was less successful in dealing with the lack of official accountability.
that the system of economic governance entailed. It took the form of much procedural injustice, rent-seeking, and corruption.

In the CHIP household survey of 2002, 21% of urban households reported corruption to be the most serious social problem; corruption came second after unemployment and layoff (Knight and Gunatilaka, 2013). Since 2002 unemployment and layoff have fallen but corruption has risen. The World Bank in its *Worldwide Governance Indicators 2015* reported China to be in the 47th percentile (from the bottom) out of 215 countries for ‘control of corruption’ in 2014, having improved from the 32nd percentile in 2010. Underlying the problem of corruption was a lack of accountability. In 2014 the *Worldwide Governance Indicators* placed China as low as the 5th percentile for ‘voice and accountability’ - the ability of citizens to voice their complaints and to hold officialdom to account.

Corruption was deemed to be so serious that the new leadership embarked on an unprecedentedly tough and serious anti-corruption campaign in 2012. Manion (2016) reports that over 400,000 officials, both ‘flies’ and ‘tigers’, were punished in the two-year period 2013-14, the powers of the anti-corruption commission were strengthened, and the relaxation of official permissions reduced the scope for rent seeking.

Corruption is likely to have contributed substantially to the growth of inequality in income and wealth, although its fruits are unlikely to be observable in household surveys. It is notable that, according to the *Hurun Rich List 2016*, China has more dollar billionaires (570) than any other country. It is not clear whether this should be viewed as a source of national pride or of policy concern! Some of the billionaires will have been successful through merit, but there may well also have been corrupt elements.
There is a view of corruption in China that runs as follows (Overholt, 2015). In China corruption has generally taken the form of ‘graft’, i.e. securing payments for doing one’s job, rather than ‘outright corruption’, i.e., securing payments to undermine national policy or the national interest. The central government had to solve the principal-agent problem that arises when there is centralised political control but decentralised economic management: it had to provide cadres with incentives to promote rapid economic growth. In that way the leadership’s ‘developmental state’ objectives could be achieved (Knight, 2014). Among the various incentives there appeared to be a tacit agreement that cadres could enrich themselves provided that they achieved government objectives in the process.

That was generally the case in 2002, when the scale of graft was being kept under control. However, it is unfortunately likely that if there is a critical mass of corrupt officials and businesspeople, an equilibrium of general corruption may well emerge. During the years of weak leadership 2002-2012, corruption increased astronomically, often through control over purchase or property allocations, and through the growing power of interest groups determined to protect and promote their own interests irrespective of the national interest. Outright corruption developed, as did abuse of power by the powerful. Oberholt (2015:24) drew the conclusion: ‘A generalised sense of unfairness spread, potentially threatening the legitimacy of the regime’.

The current anti-corruption campaign can be viewed as a response to that threat. It is liable to stem the rise in inequality that might emerge from corrupt behaviour, and to foster popular public support. However, the campaign also frightens and immobilizes the officials who are expected to promote the developmental state and to implement economic
reforms. This is one possible reason for the current slowdown of China’s growth rate. The inequalities that arise from widespread corruption or entrenched vested interests can be reversed only at some economic or political cost.

4. Conclusion

At the conceptual level, our notion of fairness is in line with ‘the idea of justice’ that is developed by Sen in his book of the same title (Sen, 2009). Sen’s objective is to provide practical reasoning about how to remedy injustice, which he equates with unfairness. To identify unfairness he adopts the appeal in Adam Smith (1759) to an ‘impartial spectator’ in order to avoid the influence of vested interests and entrenched attitudes. In the Chinese case we partly adopt the same criterion (for instance, examination of the sources and determinants of wage inequality) but we also define unfairness partly in terms of people’s own perceptions, based on national household surveys (for instance, reported attitudes, and effects on subjective well-being).

There is a third dimension of inequality, no less important than inequality of income or inequality of economic power. That is inequality in the provision and funding of public services. It raises the same issue of the need to distinguish between the fairness and unfairness of differences among various recipient groups. However, that large topic lies beyond the scope of this paper.

The types of inequality examined in this paper have as yet received little attention in the research literature on China. Accordingly, our argument is necessarily tentative, and some of the evidence that was adduced might be dated. For instance, with the great increase in rural-urban migration that has taken place since 2002, and with the spread of the internet to many more people in recent years, it is possible that
reference groups have changed and become broader. This would have implications for the effect of relative income across broader orbits of comparison on subjective well-being, possibly reducing happiness.

The notion that perceptions of fairness or unfairness in the distribution of income are more important than the distribution itself is not new in China. However, it is relatively new in China’s social science research. Similarly, perceptions of fairness or unfairness resulting from the unequal distribution of economic power, and its use or misuse, deserve more investigation. The task is to find ways of gathering relevant information in this sensitive area.

New research is needed to investigate these ideas further. This can be done by means of sample surveys, including CHIP surveys.

1. Introduce attitudinal questions which probe into people’s notions of fairness, in regard to types and sources of income, to forms of public service provision, and to abuses of economic power.
2. Introduce questions on subjective well-being which enable happiness or life satisfaction to be analysed in terms of personal characteristics, including personal attitudes, household characteristics, and community characteristics, including local governance issues.
3. Introduce questions about people’s reference groups, i.e. those with whom people make comparisons, in particular distinguishing narrow and broad reference groups.

In summary, the analysis of this paper suggests the following answers to the question posed in its title.

1. The evaluation of income inequality requires a normative judgement: even an apparently objective measure such as
the Gini coefficient contains an implicit normative judgement.

2. The aggregate Gini coefficient of income inequality is a potentially misleading guide for making a normative judgement — both because it takes no account of the fairness or unfairness of income differences and because it is too aggregative to link to the relevant normative issues.

3. It is helpful where possible to distinguish two main sources of income inequality: those which promote economic efficiency (for instance, based on merit, effort, or risk-taking) and those which do not. The latter might be regarded as unfair (for instance, corruption and rent seeking, forms of discrimination and segmentation, inequality of opportunity, or disequalising institutional arrangements).

4. It is relevant to bear in mind that people’s frames of reference can be narrow and varied — so making people more sensitive to some forms of income inequality than others.

5. It may be important to investigate the effect of income inequality on the inequality of happiness.

6. It is relevant for researchers to understand the objectives that underlie government policy towards income inequality.

7. People’s concerns might be more about inequality of power relations in society, and its unfair effects, than about inequality of income.
8. Among other consequences, inequality of power generates inequality of income, the unfairness of which may be particularly disliked.

9. In the study of inequality in China, and no doubt elsewhere, there is a case for research and research instruments to explore and develop an economics of fairness and unfairness.

References


Table 1. Trends in the Gini Coefficient and its Components, 2002-2013

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2007</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>National Gini</td>
<td>0.46</td>
<td>0.49</td>
<td>0.45</td>
</tr>
<tr>
<td>Urban Gini</td>
<td>0.32</td>
<td>0.34</td>
<td>0.36</td>
</tr>
<tr>
<td>Rural Gini</td>
<td>0.37</td>
<td>0.37</td>
<td>0.42</td>
</tr>
<tr>
<td>Urban-rural income p.c. ratio</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Not ppp-adjusted</td>
<td>3.13</td>
<td>3.83</td>
<td>2.45</td>
</tr>
<tr>
<td>Ppp-adjusted</td>
<td>2.10</td>
<td>3.02</td>
<td>2.02</td>
</tr>
</tbody>
</table>

Sources: Li Shi et al. (2013), Luo Chuliang et al. (2016).

Notes: The Gini estimates are weighted and corrected for purchasing power parity across areas. Rural-urban migrants are included in the national sample.
Table 2. Coefficients on Absolute and Relative Household Income per capita in Happiness Functions, Rural and Urban Residents, 2002

Rural residents

<table>
<thead>
<tr>
<th>Ln income</th>
<th>Income relative to village average:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Much above</td>
</tr>
<tr>
<td>0.070***</td>
<td>0.218**</td>
</tr>
</tbody>
</table>

Urban residents

<table>
<thead>
<tr>
<th>Income in each quarter</th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.181***</td>
<td>0</td>
<td>-0.091</td>
<td>-0.328***</td>
<td>-0.814***</td>
</tr>
</tbody>
</table>

Source: Knight and Gunatilaka (2010).

Notes: The coefficients are estimated from happiness functions. The variable absolute income is measured by ln household income per capita, and the variable relative income is measured differently in the two samples, according to the available data. For the rural sample, four dummy variables are estimated according to whether the household considers its living standard to be well above, above, below or well below the village average (which is the base category). For the urban sample, three dummy variables are estimated, according to whether the household considers itself to be in the 1st (highest) quarter (Q1, which is the base category), 2nd quarter, 3rd quarter, or 4th quarter. Ln income per capita was also instrumented and the instrumented coefficient was in each case somewhat higher than the OLS coefficient but the relative income coefficients were hardly affected.