

Andrew Batson

abatson@gavekal.com

Thomas Gatley

tgatley@gavekal.com

With lower-income households now experiencing faster income growth, inequality is narrowing

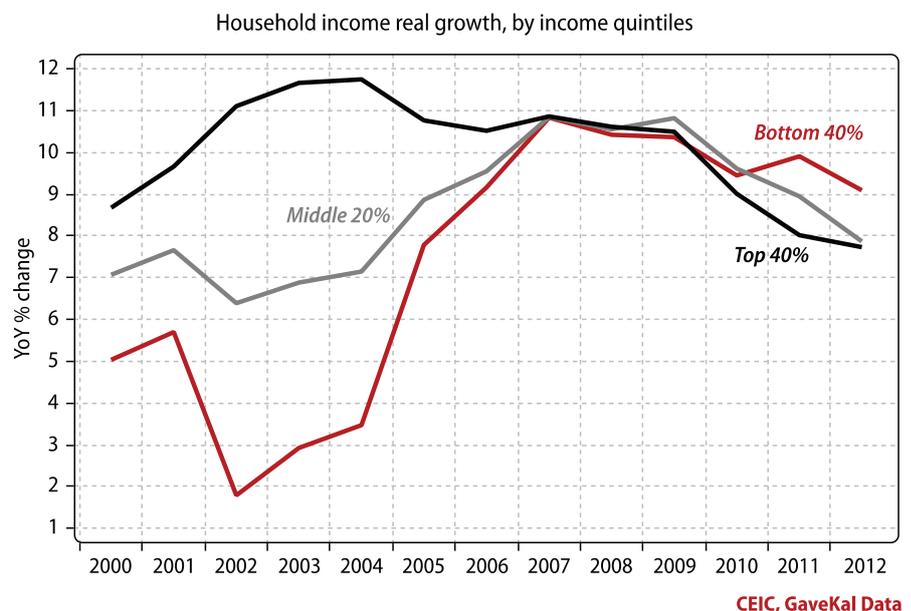
This is a result of changes in the labor market rather than social policy overhauls

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Inequality Is Improving, Discontent Is Not

Most of the news about China's economy over the past few years has not been very good: growth has been on a steady downward slide, debt has piled up and housing prices have continued to climb. Yet there is at least one exception: while other things have been getting worse, China's income inequality has been quietly getting better. Most observers have either not recognized this trend or actively denied it (the OECD's China desk is an honorable exception), but the evidence nevertheless is accumulating. All the data show households with humbler jobs and lower incomes enjoying faster income growth than those with fancier jobs and higher incomes.

Trading places: China's lowest incomes are now rising the fastest



The narrowing of income gaps is not driven by an overhaul of social policy or a fundamental change in China's economic growth model, which critics continue to insist are necessary. Rather it is simply the function of the major changes in the labor market that have occurred since 2009, themselves a result of shifts in demographics and educational policy. But the narrowing of inequality does promise to have broader economic effects, due to the simple fact that poorer households are more likely to spend their new income than richer households. Falling inequality means GDP growth should be translating into more household consumption than in the past—a trend that could help cushion the severe slowdown in investment.

Since China's still-wide income gap is usually thought to be a cause of social unrest, the narrowing of inequality should also in theory be alleviating the tensions that threaten political instability. Yet this diagnosis of the effects of inequality is as off-base as the popular account of its causes. The crucial point here is that *politically relevant* inequality is not the same

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Ordinary people may not notice a change in relative wages, since they are more concerned about other issues

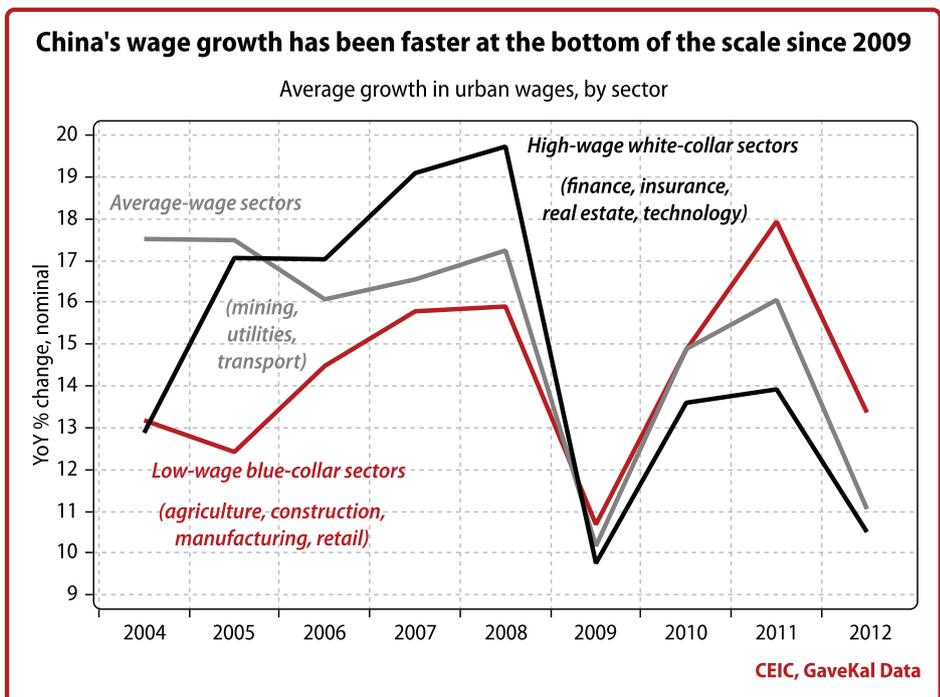
China's blue-collar and white-collar job markets are largely separate

The blue-collar job market is delivering faster wage gains than the white-collar one, a reversal of the old pattern

thing as *economically measurable* inequality. Most Chinese people are not concerned about the Gini coefficient, or the ratio between urban and rural incomes, but rather the gap between the people with connections and people without them. In other words, they worry about the fairness of the political and economic system—and here most indications are that they feel that the problem is getting worse not better. We would even argue that the forces reducing inequality—essentially, the compression in the income growth of urban white-collar workers—could intensify rather than soothe social tensions. But to better understand the causes and consequences of a thinner income gap requires a close look at China's job market, to which we now turn.

Separate and unequal

China does not have one job market but two: just as its household registration (*hukou*) system divides the population into urban and rural, the job market is segmented into distinct pools. In what for simplicity's sake we would call the "blue collar" urban job market—manufacturing and construction, but also low-end service jobs like retail—the supply of new workers comes from young people migrating from rural areas. In the "white collar" job market, for higher-end service-sector jobs, the supply of new workers is mainly new university graduates. Because few Chinese university graduates are willing to lower themselves to work with their hands, and because few migrants have the skills or social graces to work in an office, the dynamics of these two job markets can be quite different.



And indeed they have been: since 2009, blue-collar wage growth has outpaced white-collar wage growth. For the high-wage, white-collar sectors of technology, finance, insurance and real estate, wage growth has averaged 12% annually, down from 17% in the five years through 2008; for the lower-wage sectors of agriculture, manufacturing, construction and retail, wage growth has stayed steady at 14% annually. This is because the balance between supply and demand is now quite different across China's two

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Slower economic growth may mean less job demand in cyclical sectors like finance

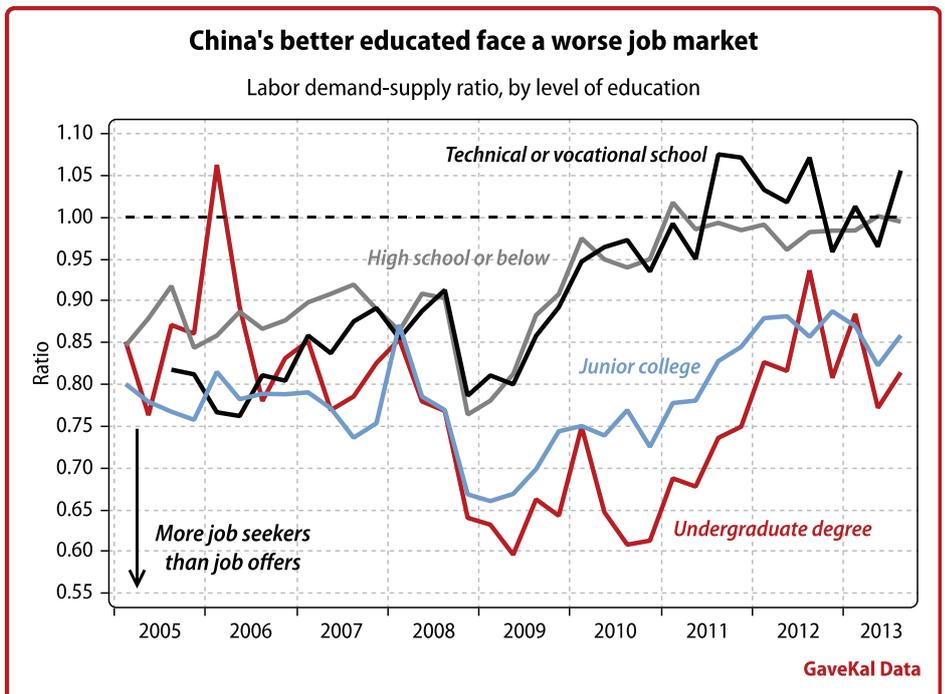
But the big difference between the two job markets is on the supply side

Surveys show an under-supply of uneducated workers and an over-supply of educated ones

labor markets. According to the labor ministry's survey of job placement centers, demand for factory, service and agricultural workers has outstripped supply since 2005. As of mid-2013 there were 125 blue-collar job openings posted for every 100 applicants, compared with 80 openings per 100 applicants for white-collar positions. This dynamic is precisely what is pushing the top and the bottom of the wage scale closer together.

But is this change in the job market due to supply or demand, to employers or employees? Clearly the overall slowdown in the economy since 2009 should mean that demand for new workers is also growing more slowly. And there are certainly real differences in demand among sectors: the high-wage sectors of finance and technology tend to be very cyclical, so their wage gains could be more affected than other sectors. Yet the economic slowdown does not seem to be a sufficient explanation: China's export growth has for instance slowed much more sharply than overall growth, and yet manufacturing wages are outperforming.

We think the supply side of the labor market is the real key to understanding the changing pattern of wage growth. Thanks to the huge expansion of university education since 1998, the number of new university graduates has risen every year: more than 6m students completed undergraduate degrees in 2011 and 2012, while fewer than 1m did in 2000. By contrast, growth in the rural migrant worker population has slowed: according to official surveys, about 5m new migrants entered the labor force in 2011 and 2012, compared with an average of 8.2m per year between 2000 and 2010. In other words, the supply of new blue-collar workers, i.e. rural migrant workers, has been constrained, while the supply of new white-collar workers, i.e. fresh college graduates, has been rising rapidly. This has had clear effects on the job market. Prior to 2008, the labor ministry's surveys show that the supply-demand balance for workers with different levels of education was not very different—but since then, they have diverged sharply, and in favor of less-educated workers.



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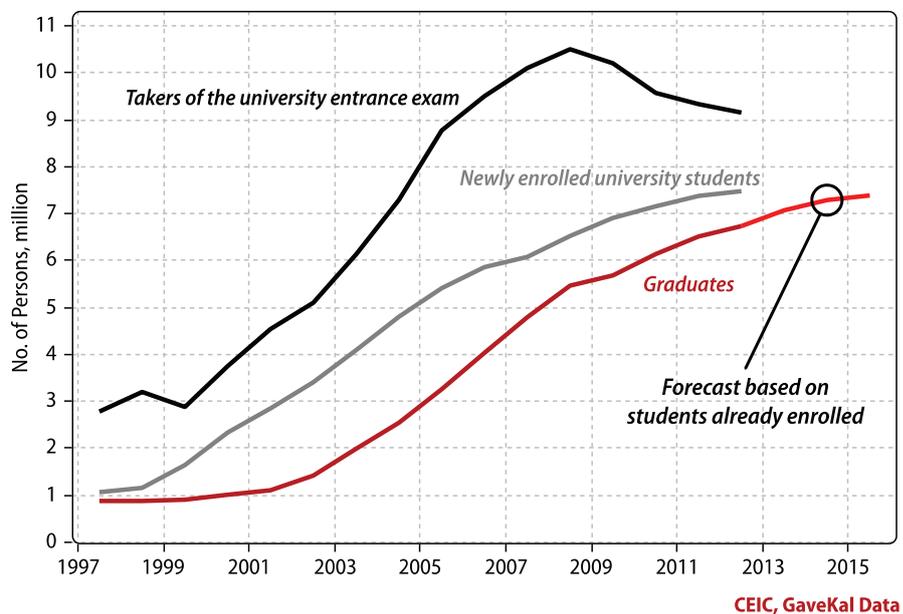
Demographics are shrinking the pool of younger workers, but this has been offset by expanded college admissions

The over-supply of college graduates will persist for years, thanks to admissions decisions that have already been made

The decision to expand university enrollment will keep the pressure on white-collar wages

In an unusual reversal of the situation in developed countries, it actually looks easier for Chinese workers with the equivalent of a high school degree or less to find a job than it is for those with an undergraduate degree. This is not news to most Chinese families: the increasing difficulties that new graduates face in the job market has been the subject of extensive local press coverage for the last few years. Of course, employers do not actually prefer less-educated workers; it is just that the supply of more-educated workers is relatively so much larger. If demographic change affected both labor markets equally this would not be the case: an aging population means that the cohort of young workers (defined as the 15-34 age group) has shrunk by 10m people since 2005, to about 420m today.

The number of new graduates hitting China's job market will keep rising



The real culprit is educational policy, which determines the number of university graduates. The number of students entering university has continued to rise in recent years—even though the number of students taking the entrance examination (*gaokao*) is actually falling because of demographic change. In other words, the government has effectively decided to lower admission standards in order to spread college education more widely. And as the future supply of college graduates is determined by today's newly-enrolled students, a steady increase the flow of new graduates is guaranteed until at least 2015, when we expect the number of new undergraduate and graduate degree holders hitting the job market to exceed 7m. This trends mean that the current dynamic of vibrant wage growth for blue-collar jobs and much less vibrant growth for white-collar jobs will persist for some time—and inequality will keep falling.

Our theory that inequality is driven by segmented labor markets calls into the question the common assertion that widening income gaps are inherent in China's "imbalanced" and investment-driven growth model (for a sophisticated presentation of this view, see this IMF [working paper](#)). If investment-led growth was really driving inequality, then as the reliance on investment has gotten worse since 2008 inequality should have also gotten worse. It did not; the unintended consequences of demographic

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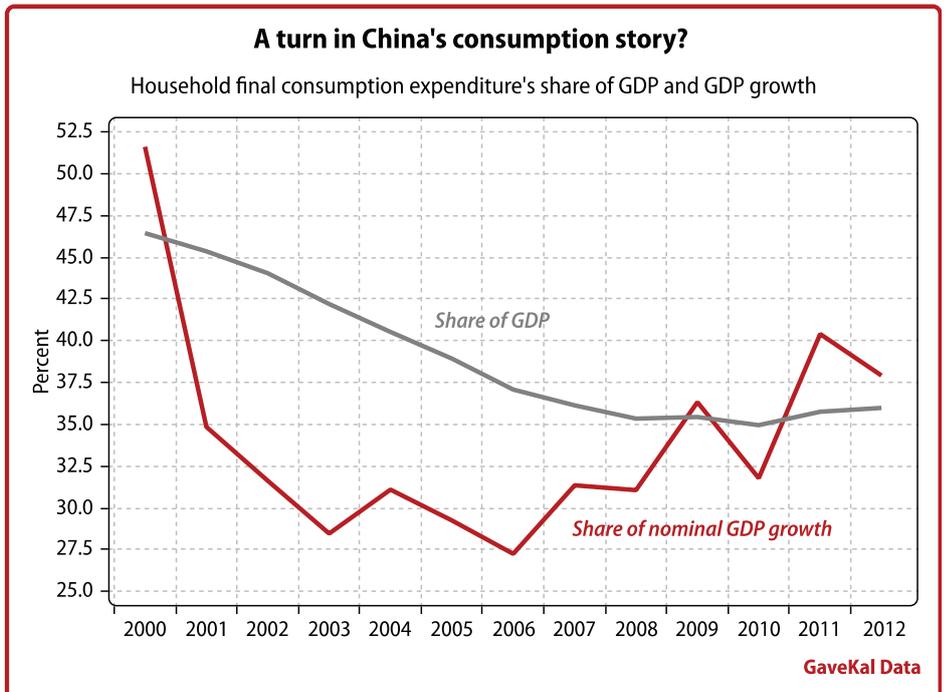
The steady rise in inequality up until a few years ago is not necessarily an indictment of China's growth model

But narrowing inequality will help future growth translate more directly into consumption

In fact household consumption's share of the economy has already begun picking up

change and educational policies turned out to be more important factors. Nor do we think the rise in income inequality in the three decades since China launched market reforms is an indictment of its growth model. As Simon Kuznets recognized long ago, the transition from a traditional to a modern economy cannot help but increase inequality. A growth take-off results from the creation of modern, high-productivity-growth sector within a slow-growing traditional economy. This obviously creates an income gap between those inside and outside the modern sector, but since overall national income is growing, and the population is gradually moving out of the traditional sector and into the modern sector, this gap is a sign of progress rather than regress.

Indeed the recent narrowing of inequality could help alleviate the investment imbalances that conventional economic opinion is so obsessed with. Lower-income groups tend to spend more of their income: the average household in the bottom 10% of the income distribution spent 89% of their disposable income in 2012, compared with 59% for the average household in the top 20%. And in fact as wage gaps have narrowed in recent years, household consumption's contribution to GDP growth has been trending upward, and the household consumption share of GDP rose in both 2011 and 2012. Given that we think the official national accounts under-count household spending, the underlying trend should be even more positive (see [China's Missing Consumption](#)). The most effective way for the Chinese government to promote consumption growth is really to support income growth, and the more broad-based this income growth, the more effectively it will translate into consumption.



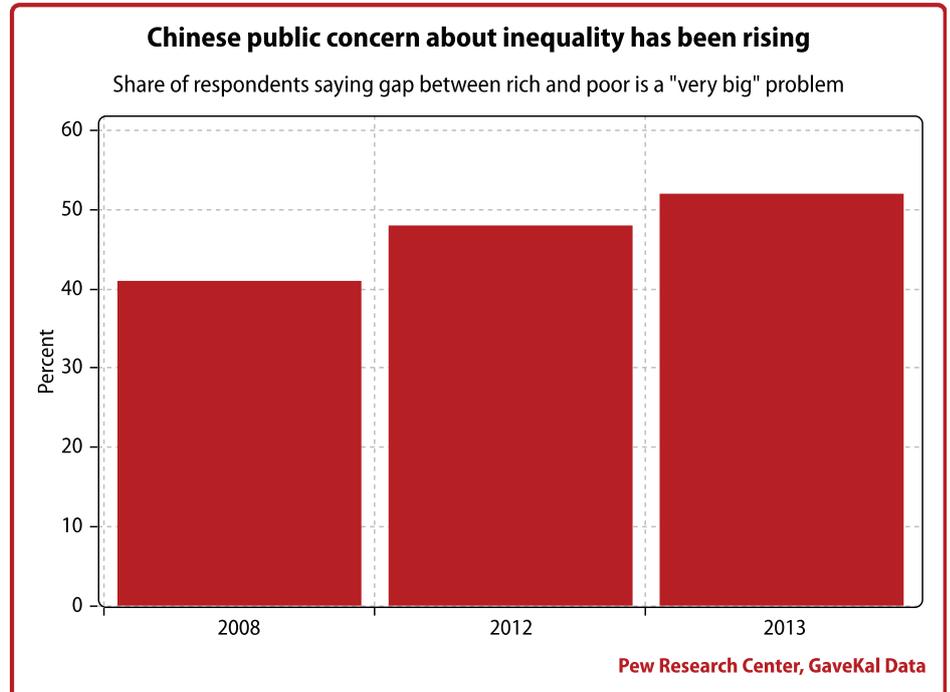
The most striking fact about the narrowing in China's economic inequality is that no one seems particularly happy about it. According to the limited number of available opinion surveys, most urban residents think inequality has actually gotten worse over the last few years. In our view, this reflects popular concern with official corruption and the privileges of state-owned enterprises, rather than an informed view on the statistical properties of the

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Popular worries about inequality are on the rise, but the real anger is at the privileges of those with government connections

The continued squeeze on white-collar wages is likely to provoke more discontent in this social class

household income distribution (see [More Unequal Than Rome](#)). This feeling is also probably exacerbated by steep housing prices in major cities: for residents of these places, it's hard to enjoy rising income as house prices are rising faster still. The narrowing gap in wages is real—it is simply less relevant than these other issues.



In fact, the way this reduction in inequality is happening could even end up creating new forms of social stress. Because of slowing gains in wages paid to entry-level white-collar workers, these workers will increasingly feel the system is not generating the returns they had expected. In China's highly status-conscious society, there is also huge pressure on white-collar workers to maintain a certain social distinction from blue-collar workers. But with the job market narrowing income gaps, it will get harder for lower-level white-collar workers to do this. While blue-collar workers should be pretty happy with current job market arrangements, white-collar workers will get increasingly dissatisfied. For China's government, dealing with the disappointed expectations of the urban bourgeoisie is only going to become more of a challenge.