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THE ECONOMIC CAUSES AND CONSEQUENCE OF SOCIAL INSTABILITY IN CHINA

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The Economic Causes and Consequences of Social Instability in China

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Abstract

Social instability is a concept that economists rarely analyse, and yet it can lurk behind

much economic policy-making. China's leadership has often publicly expressed its

concern to avoid 'social instability'. It is viewed as a threat both to the political order and

to the continued rapid growth of the economy. This threat to growth in turn endangers the

maintenance of social stability. This paper examines the likely economic determinants of

social instability, using both surveys and other evidence. After explaining the

determinants of China's rapid growth, the paper goes on to examine the likely

mechanisms by which social instability can affect the growth rate. There is a case for

more research on the role of social instability in the economic development process.

Key Words: China; civil unrest; corruption; developmental state; economic growth;

governance; happiness; inequality; social instability

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1. Introduction

It is relatively unusual for development economists to analyse the economic causes and consequences of social instability. Yet it is not unusual for governments of developing countries to worry about social instability, especially if they lack democratic legitimacy. This worry can in turn be important to their economic policy-making. The Chinese government during the period of economic reform provides a good example. Social instability is viewed as a threat both to the political order and to the continued rapid growth of the economy. China's leadership has often publicly expressed its concern to maintain social stability. For instance, according to Shirk (2008: 52), the term 'social (in)stability' had appeared 700-800 times a year over the previous decade in the *People's Daily*, a Chinese Communist Party (CCP) mouthpiece.²

There is evidence that social unrest, as proxied by a proliferation of citizen protests and petitions, has indeed been rising in China. The number of 'mass incidents' (cases of civil unrest, officially recorded) rose from under 9,000 in 1993 to 180,000 in 2010³. Minzner (2006: 1) quotes a statement of a public security official to the effect that the foundation of social order in China is fragile and that social stability is achieved within an environment of 'unceasing, tough public security measures'.

It is arguable that such concerns have 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. In this way China became a 'developmental state' (Knight and Ding 2012). For the first quarter of a century of economic reform, rapid growth was viewed as the one true path to secure political

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¹ Notable exceptions include Aisen and Veiga (2011), Alesina and Perotti (1996), Alesina et al. (1996), Campos and Nugent (2002), Collier and Hoeffler (2004), Easterly et al. (2006), Mauro (1995), and Perotti (1996). Most of these are concerned with consequences rather than causes, and with political shocks greater than any experienced by China during its period of economic reform.

² There might be some overstatement of the danger insofar as the CCP wants to portray itself as the bulwark against chaos.

³ The figure was not officially reported beyond 2008 (when it was 127,000); the figure for 2010 is attributed to Sun Yiping of Tsinghua University.

legitimacy and to avoid social instability. However, the remarkable transformation of China's economy and society that rapid growth entailed itself posed new threats. The leadership's subsequent secondary objective of achieving a 'harmonious society' is a response to the need to maintain social stability in the evolving circumstances.

The methodological difficulties confronting economic research into social instability are to measure this elusive concept, the effects of its hypothesised economic determinants, and its hypothesised effects on economic outcomes. The more authoritarian the state, the more difficult it is for researchers to obtain the relevant information. We draw extensively on a multipurpose national household survey which asked many socioeconomic questions - but not the ideal ones for the current purpose. We also draw on relevant official sources and international surveys, as well as the academic literature on this issue.

In sections 2-5 we examine the likely economic sources of social instability, concentrating on income and its change in section 2, inequality in section 3, insecurity in section 4, and institutions and governance in section 5. The factors underlying China's virtuous circle of rapid growth are explained in section 6, and the possibility of social instability generating an adverse shock that might break that virtuous circle is examined in section 7. The concluding section 8 considers the implications of the analysis for policy and for research.⁴

2. The causes of social instability: Income and its change

In order to analyse the causes of social instability in China we examine the determinants of subjective well-being. The reasoning is that unhappy people, dissatisfied with life, are more likely to be socially discontented than happy people, and that the causes of unhappiness suggest pointers to the sources of social discontent. The China Household Income Project (CHIP) national household survey of 2002 provided questions on

⁴ The paper draws on parts of Chapter 12, 'Economic growth in China: prospects', of Knight and Ding (2012).

subjective well-being, and there was a separate module on subjective well-being in the questionnaire for the rural subsample.⁵ In this way it is possible to analyse the effects of income and its growth, economic inequality, and economic insecurity on subjective well-being.

The key dependent variable is derived from the question, common to all three subsamples: how happy are you nowadays? Five possible answers were allowed: very happy, happy, so-so, not happy, not at all happy. This can be used as a cardinal variable (with the answers being scored 4, 3, 2, 1 and 0 respectively) or as an ordinal variable. In the former case linear regression, and in the latter case ordered probit analysis, is conducted. Both were estimated but in no case did the choice of method affect the interpretation significantly. We report only the cardinal results as they are simpler to interpret. In the rural subsample, for which a separate question on satisfaction with life was available, the choice of dependent variable made no significant difference to the interpretation: the terms subjective well-being, life satisfaction, and happiness are used interchangeably.

Analyses of the 2002 survey are reported in Knight et al (2009), Knight and Gunatilaka (2010a, 2020b, 2011, 2012). A striking feature of the results for all three subsamples – comprising rural, urban and migrant households – is their regularities. Many coefficients are statistically significant, generally understandable, similar across samples, and in line with the results from other countries or contexts. The happiness functions are meaningful and informative although there can be disagreement about the conclusions that should be drawn from them.

It is a universal finding in happiness studies around the world that happiness rises with income in the cross-section - in line with theoretical expectations. This is true also of China, and in all three subsamples of the CHIP 2002 data set (for instance, Knight and Gunatilaka 2011). The effect of instrumenting income is to raise its positive coefficient,

4

⁵ Designed by the author with funding obtained from the Oxford-Manchester Global Poverty Research Group, supported by the UK ESRC.

possibly because unobserved characteristics, such as ambition, which raise income are associated with higher aspirations, which lower happiness. Even in the urban sample, for which the income coefficient is highest, the size of the effect is surprisingly small both absolutely and by comparison with the effect that various other determinants, discussed below, have on happiness: a doubling of income raises the happiness score by only 0.22 units (Knight and Gunatilaka 2011: 9).

Two studies have been made of the role of perceived change in income over the previous five years. Knight et al. (2009: 639) used a question in the rural survey: 'how has your household's living standard changed over the last five years?'. The answers permitted were: better, the same, or worse. It was found that current happiness was sensitive to the perceived change in income. For instance, by comparison with no change, a past fall in income decreased current happiness by 0.18 units and a past rise increased it by 0.18 units.

Research by Appleton and Song (2008) was designed to examine the causes of social discontent: it was the pioneering empirical economic study of social instability in China, and it did so indirectly by analyzing life satisfaction⁶. The authors found for the urban sample that there were fairly high reported levels of satisfaction with income growth over the previous five years, and also that satisfaction with income growth had a positive multivariate correlation with overall life satisfaction. They concluded that the previous rapid average growth of incomes was important to current life satisfaction, and so might have provided some protection against social instability.

Studies have been made of the role of expected future income on current happiness (Knight et al 2009) for rural residents, Knight and Gunatilaka (1010a, 1010b) for ruralurban migrants and urban residents respectively, and Knight and Gunatilaka (2011) and also Frijters et al. (2012) for all three subsamples. The key variable entered in the happiness equation was 'how do you expect your income to change over the next five

⁶ The authors analyzed a module attached to the CHIP 2002 survey that contained a question specifically about satisfaction with life.

years: to decrease, be the same, increase a little, or increase a lot? Each of these studies found that that expected future income had a statistically significant and substantively large positive effect on current happiness. In the urban subsample the difference between expecting a large increase and a decrease accounted for 0.55 units of happiness (Knight and Gunatilaka, 2010b: 526)

Knight and coauthors found that current happiness was positively related to expected income change in all three subsamples, and that the effect was relatively large by comparison with the effect of current income. Whereas permanent income theory implies that future income enters current utility only through its effect on current consumption, the substitution of consumption per capita for income per capita in the happiness function made no difference to the coefficients on the expected future income terms. It appears that anticipations of future income enter directly into current happiness, and that a fall in expected future income would reduce current happiness.

The paper by Frijters et al (2012) which, unlike the others, concentrated solely on this variable, found that the expectation of future income on happiness was generally buoyant and that its effect on happiness was important even after correction for endogeneity. After conducting counterfactual simulation analyses, these authors concluded that expectations of future rapid income growth helped to explain China's apparent social stability despite the immense socioeconomic transition that previous rapid income growth had brought. The simulations also implied that a reversal of income expectations would cause a sharp immediate fall in levels of happiness, which, they surmised, could have implications for social instability.

The sensitivity of subjective well-being to both past changes and expected future changes in income implies that subjective well-being depends on income relative to reference time. Sociological research suggests that people are better able to remember, or project, their income than they are at remembering, or projecting, their aspirations (Rabin 1998). Thus aspirations tend to be anchored in the present.

The argument of this section suggests that higher income is good for happiness and that economic growth, both perceived past and expected future, is good for current happiness. This is very much in line with Chinese government thinking: higher living standards, and improvements in living standards, help to keep people happy and, by implication, provide protection against social instability. Between 1990 and 2008 household income per capita increased in real terms by 8.4% per annum. Surely, average happiness rose over that period? Yet Easterlin et al. (2012) find otherwise. The authors draw together all the available pieces of evidence on life satisfaction in China in the period 1990-2010 to provide a time series, and conclude that overall there was no increase in life satisfaction between the start- and the end-year. Their explanations, and those of Knight (2012) and Knight and Gunatilaka (2011), lie in the profound socioeconomic changes in society that accompanied that growth. We examine these changes in sections 3, 4 and 5.

3. The causes of social instability: Inequality

The rise in economic inequality that has accompanied economic reform and economic growth poses a threat to social stability. Having been very low by international standards at the start of economic reform, the national Gini coefficient of household income per capita was 0.40 in 1988 (then mainly regional) and 0.49 in 2007 (then the joint highest in Asia). The increase in income inequality took three main forms: inequality among households, across regions, and between urban and rural areas.

As an urban labour market gradually emerged along with economic reform, the wage structure widened and wage inequality rose. For instance the Gini coefficient of urban wages was 0.21 in 1988 and 0.33 in 2007 (Deng and Gustafsson 2012). The rise was partly due to increasing rewards for productive characteristics and incentives for efficiency: for instance, the wage premium of a college degree over primary schooling was 9% in 1988 and 88% in 2007. However, it was also partly due to new or growing

⁷ Derived from *China Statistical Yearbook* by combining the figures for urban (8.1% per annum) and rural households (6.2% per annum) and allowing for the growing weight of urban households in the total.

⁸ As measured in the CHIP surveys of 1988 and 2007; the comparison with other Asian countries is from Asian Development Bank (2007).

forms of discrimination and segmentation – by sex, ownership, enterprise profitability, region, and social connections (Knight and Song 2007; Knight and Yueh 2008). Income differences that are due to productivity and effort might appear to be justified whereas those that arise for other reasons might arouse feelings of distributional injustice

The research on subjective well-being in China shows the importance that people attach not only to their absolute income but also to their relative income. Happiness is increased by absolute income but it is decreased by aspirations, which are determined by income in society. That is one reason for the finding, referred to above, that happiness scores over time have failed to show an increase in happiness despite the rapid growth of incomes in China. However, trends in inequality at the national level, or across regions, or between urban and rural areas may not be important in fermenting social instability. The research on subjective well-being also shows the importance to aspirations of a person's reference group, that is, the people with whom comparisons are made.

Rural people have narrow reference groups: when asked with whom they mainly compare themselves, 68% reported that it was fellow-villagers and neighbours. It is their position in the village income distribution that matters most. Thus, conditioning on income level, those who reported that their income was much above the village average (on a five-point scale) had an average happiness score higher by 1.06 units than those reporting to have income much below the village average (Knight et al. 2009: 639). Urban residents and also rural-migrants settled in the city are sensitive to their position in the income distribution of that city. Urban resident reporting to be in the top quarter had a conditional average happiness score 0.93 units higher than those in the bottom quarter; the equivalent figure for rural-urban migrants was similar (Knight and Gunatilaka 2011: 9, 17). Social discontent may thus be a local matter.

Urban respondents were asked what they considered to be the most important social problem. It is suggestive that those who answered that it was social polarisation had

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⁹ See, for instance, Knight and Gunatilaka (2012), which analyses a proxy for the income to which a person aspires.

significantly lower happiness, with the negative coefficient being largest for those in the lowest income tercile of the city (Knight and Gunatilaka 2010b: 528). It is plausible that the rapid socioeconomic and ideological changes and the more competitive environment had disrupted the previously closely regulated and ordered lives of city-dwellers, so creating a state of 'anomie', defined by Durkheim as normlessness. The survey did not have good attitudinal questions to identify anomie but it contained some suggestive pointers (Knight and Gunatilaka 2010b: 529-30).

Migrant households settled in the city but having rural *hukou* registration were found to have the lowest mean happiness of the three subsamples. This was partly because they had transferred their reference groups from the village to the city, but also because they were subject to various forms of economic and social discrimination in the city. For instance, job dissatisfaction, perceptions of discrimination, and a proxy for economic insecurity each reduced happiness (Knight and Gunatilaka, 2010a). The inequality of opportunity due to migrant status is a potent source of social instability in a country that now has 150 million or more rural-urban migrants..

Easterlin et al. (2012) found evidence of a marked increase over two decades in inequality not only of income but also of life satisfaction scores. This finding is in line with the positive association between household income per capita and life satisfaction that is revealed by the cross-section data. However, the plausible hypotheses that the effect of relative income on life satisfaction becomes more important, and that mean life satisfaction falls, as the inequality of income rises (and thus, social cohesion is weakened) remains to be tested in China.

Whyte (2010) conducted a national sample survey in 2004 to make a sociological study of Chinese attitudes towards inequality. He found that 71% of respondents reported the first two ('too large' or 'somewhat large') of five possible classifications of the national 'income gap', but the proportion was smaller (40% and 32% respectively) to questions about the workplace and the neighbourhood income gaps (Whyte 2010: 44). He also

found that 51% of respondents 'agreed' or 'strongly agreed' that the income gap threatened social stability (Whyte 2010: 45).

Nevertheless, the conclusion drawn from the survey evidence taken as a whole was that Chinese people were in general not averse to the degree of inequality that they observed, particularly if it was based on merit, effort or risk-taking. Inequality, like rapid economic growth, appeared to offer people opportunities for improving their economic positions. This interpretation corresponds to the first stage of the 'tunnel effect' hypothesised by Hirschman and Rothschild (1973)¹⁰. By contrast, inequality based on unfairness in access to opportunities was generally disliked. China's semi-marketized economy offers much scope for such sources of inequality – which might arise from connections and corruption or from institutions and policies that put some people (such as rural residents and rural-urban migrants) at a disadvantage. It was notable that injustice was felt more strongly in urban areas, especially among unskilled and semi-skilled workers, than in rural areas, and least among farmers, who are the poorest group. Actual income is a poor guide to perceived distributional injustice because people's information sets and their aspirations are also important.

There appears to be an inconsistency between Whyte's finding that people accept income inequality in itself, that is, they may view it as a good signal, and the findings of Knight and co-authors that local incomes relative to own income reduce subjective well-being, that is, they may experience relative deprivation. Knight et al. (2009) provide a possible reconciliation. They find that subjective well-being is lowered by other incomes in the village but raised by income inequality in the county, as measured by the Gini coefficient. This suggests that inequality, as it touches people most closely, reduces happiness, but when it is viewed more broadly, is perceived to offer opportunities for higher income.

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¹⁰ They illustrated the possibility of changing tolerance for inequality in a developing country as follows. Two lanes of cars are stuck in a tunnel. If one lane begins to move, this is initially welcomed by drivers in the other lane because it suggests that their turn will come soon. However, this may eventually turn to anger if their lane continues to remain stuck.

Peering into the future, two important developments may affect the relationship between inequality and social instability, but they are likely to work in opposite directions. First, the dramatic socioeconomic changes that are occurring in China, such as the increasing number of migrants and the growing use of the internet, are probably broadening people's reference groups. This may make happiness increasingly sensitive to income differences over wider orbits of comparison. Second, the trend in income inequality will depend on the balance of countervailing forces. Although various forces that have raised China's income inequality over the reform period are likely to continue to operate, two main equalising factors will grow in importance. It is predictable that the labour market will tighten as China enters the second stage of the Lewis model and the fruits of economic development are more widely spread (Knight et al. 2011). Moreover, the growing scarcity of labour and other resources can be predicted to transfer production from the coastal provinces to the poorer, interior, provinces.

4. The causes of social instability: Insecurity

Prior to the reform of the state-owned enterprise (SOEs), which started in the mid-1990s, urban resident employees had enjoyed iron rice bowls – lifetime employment in mini welfare states provided by their employers. Over the following decade the urban economy underwent the drastic reforms needed to sustain rapid growth. The SOEs were closed, privatised or reformed, and many millions of their workers were made redundant. The iron rice bowl provided by firms collapsed and its replacement by broader social insurance arrangements was tardy and incomplete. Urban unemployment – both actual and threatened – rose sharply from previous very low levels and only gradually declined.

Easterlin et al. (2012) found that, although the life satisfaction score in China was no higher in 2010 than it had been in 1990, it had followed a U-shape in-between, its lowest point being in the period 2000-2005. Their interpretation of the U-shape was mainly in terms of the urban unemployment rate. The low point in life satisfaction matches the high point in unemployment and in people's sense of insecurity.

It is consistent with this interpretation of the U-shape that analysis of the 2002 CHIP survey found that the mean subjective well-being of rural residents was higher than that of urban residents, despite the much higher mean income of the latter subsample (Knight and Gunatilaka, 2010b). Conditioning on income, the mean urban resident happiness score was reduced by the respondent having been made redundant, and by a proxy for the probability of future unemployment. The implication of these results is that a sudden economic downturn could create unhappiness and social discontent.

Two new sources of insecurity can be mentioned, both pointing to the need to study their effect on the subjective well-being of young people and their parents. One is the impact on the labour market of the great expansion of higher education from 1999 onwards. In 1998 higher education enrolment was 3.4 million and in 2008 it was 20.1 million – nearly six times its level a decade earlier. The short term labour market consequences were severe, taking the form of a rise in unemployment among graduates, a longer average duration of their unemployment, and the gradual acceptance of jobs previously entered by non-graduates or of 'graduate jobs' at lower pay. Another new source of insecurity is the very uneven sex ratio among young people: official statistics show the ratio of males to females to be 1.21, 1.15 and 1.14 among young people aged 5-9, 10-14, and 15-19 respectively in 2008. This generates intense marriage competition among young men and their parents. There is evidence that the high sex ratio does indeed alter household behaviour. For instance, Wei and Zhang (2009) find that households with a son increase their saving in a competitive manner in order to improve their son's relative attractiveness in marriage. Knight et al (2010) find that rural households with a son have higher conditional income, which, after tests, they attribute to the incentive to provide for their son. Job and marriage disappointment and insecurity might well reduce people's well-being.

5. The causes of social instability: Governance

Even after more than thirty years of economic reform China still has a semi-marketised economy, involving much state intervention. This intervention serves both a political and

an economic function. It ensures that the CCP remains in political command and generates formidable patronage resources for that purpose; it also provides the policy instruments to achieve and maintain a developmental state. However, the semi-marketised economy is a breeding ground for rent-seeking and corruption of bureaucrats and party officials, especially at local levels.

Corruption is a potentially serious source of social discontent. The issue is not played down by government: Hu Jintao is said to have described corruption as 'rampant' (Shirk 2008: 32), and to have stated that the resolute punishment and effective prevention of corruption is essential for the survival of the CCP (Wedeman 2009). It is difficult to gauge the extent of corruption in China but the World Bank's annual 'worldwide governance indicators' provide a clue (World Bank 2011). The bank combines several independent evaluations to produce six indicators of the quality of governance in each of 235 countries, one of the six being 'control of corruption'. In 1996, 42% of countries had a better score on this measure than China, and in 2009 the proportion was 63%, so that China then ranked 148th out of 235 countries. However, it is the perception of China's people that better indicates the threat to social stability posed by corruption. Respondents in the urban subsample of the CHIP 2002 survey were asked what they considered to be the most serious social problem. Corruption (reported by 21%) along with lack of social security (also 21%) was placed second, after unemployment and layoff (32%).

The central leadership has launched a series of high-profile anti-corruption campaigns (Yao 2010: 333). However, the underlying problem is that China's institutional arrangements and governance system make it prone to corruption. Moreover, the problem facing the CCP is that the system of patronage, which is prone to corrupt practices, helps to maintain it in power, and that corruption, by distributing rents among the powerful, also helps to do so.

Minzner (2005) provides evidence of rising social unrest in recent years, as proxied by a growing number of citizen protests and petitions. He points to flaws in China's governance that mean that citizens lack both independent political institutions to

participate in the decisions that affect their lives and independent legal institutions to protect their rights. As a result, people's grievances have been channelled into mass protests and petitions.

Much of the social unrest is due to citizen dissatisfaction with local government actions, including corruption and illegality, arbitrary or excessive taxation, and neglect of pollution. The confiscation of land or property without adequate compensation is a widespread source of complaint. Here the actions of local officials are often to be explained by rent sharing with developers, with the proceeds going into either local government coffers or their own pockets. The system of governance creates opportunities for abuses of this sort because the accountability of local officials is so weak: they enjoy extensive control over the local media and judiciary, local legislators and village committees. Higher tiers of government attempt to restrict such abuses by means of incentive structures, for instance by using the degree of local social unrest as a criterion for disciplining, rewarding and promoting local officialdom. However, this also produces the perverse incentive for local officials to stifle the expression of discontent through intimidation or coercion (Minzner 2006). In these ways, the institutions of governance fuel social unrest, in the form of citizen petitions and mass protests.

Both the power and the limits of protest are illustrated by the incident in Wukan, a village in Guangdong, in 2011. Village officials sold land to property developers without properly compensating the villagers. The people of Wukan, who had previously petitioned higher tiers of government in vain over the land dispute, launched a protest which escalated. Some of their representatives in negotiations were taken into police custody, and one of them died. The residents forced local CCP officials and police out of the village, and the police then laid siege. There was attempted internet censoring of the incident, and Chinese newspapers did not report it until a settlement had been reached. The agreement - meeting the villagers' immediate requests and implicitly acknowledging their grievances - came after the provincial government intervened.

Although the remedy for discontent commonly lies with local officials – who disregard legitimate complaints – it is often sought in more effective police control, as was initially the case in Wukan. Underlying the Wukan incident was the fiscal pressure on local governments, especially after central government appropriated 50% of the tax on local enterprise profits in 2002 and abolished the agricultural tax in 2006, which meant that they increasingly raised funds by selling land at market prices while normally compensating the land-holding community with only a small fraction of the proceeds (Kung et al. 2012). It is notable that the Wukan villagers' complaints were against local officials and not the CCP more broadly. For them the best hope of success was to secure the support and intervention of higher tiers of government. Expressions of social discontent such as this one are not a threat to the political order because they are localised and lack coordination. Many may never have been reported. Nevertheless, the fact that some receive more publicity than in the past, through the internet and the media, and the radicalisation of protesters, increases the probability of wild fire or bandwagon effects.

A survey of local officials found that 'upholding social stability' was reported to be the most critical task they faced (Minzner 2005: 19). A 2005 survey of local bureau heads found that almost two-thirds perceived rapid economic development to be the most important means of maintaining social stability (Minzner 2005: 19, 20). The central government response to the threat has taken two main forms. Up to about 2005 rapid economic growth was viewed as the overriding means of protection against social instability. Since then a second objective has been added: top leaders have repeatedly linked their goal of a 'harmonious society' with that of avoiding social instability. However, it is arguable that the underlying problem remains: that is, the unreformed system of governance. The obstacles to reform of governance have been both political and economic: not only the CCP's determination to maintain its monopoly of power and patronage but also its decentralisation of monopolistic powers to local officialdom in order to implement the developmental state objectives at local levels.

6. The virtuous circle of rapid growth

The purpose of this section is to show the ways in which China's economic growth may be vulnerable to an adverse shock. It explains how the Chinese economy entered a virtuous circle of high confidence, high investment, high growth, high confidence, and so on. The explanation in turn invites the question posed in Section 7: can the virtuous circle be maintained?

The reform leadership that came to power in 1978 gave overriding policy priority to rapid economic development in order to restore the political legitimacy that had been lost during the years of stagnating living standards, the Great Leap Forward, and the Cultural Revolution. This involved overturning the inefficient incentive structures that had previously prevailed and replacing them with incentives designed to achieve the new policy objective. One set of incentives involved harnessing market forces but the other, less obvious, set was designed to solve the principal-agent problem. With the abandonment of central planning, central government delegated many responsibilities and powers to lower tiers of government, so creating a need for central government to control local governments.

The leadership addressed the principal-agent problem by putting in place incentives for local governments to pursue its growth objectives. The incentives were primarily three-fold. One was fiscal decentralization: local governments benefited from local economic development through the effects it had on their revenues and expenditures. Another was directed use of patronage inherent in the hierarchical system of permissions and refusals. The third was the *nomenklatura* system of state appointments and promotions at every level of government. Evaluation of officials is based on their performance in achieving state objectives and targets, set in terms of economic growth. Similarly, the harmonious society policies of recent years have been pursued partly by rewarding local officials for achieving the state's redistributive objectives, such as introducing and raising city minimum wages.

Thus, not only did the bureaucracy not resist reform but it was often willing and able to lead reform. Reform proceeded by a series of positive feedback loops. It was governed by

two criteria: it had to be efficiency-enhancing and it had to be interest-compatible. Interest compatibility was assisted by incentive structures and ensured in the early years up to the mid-1990s because it was 'reform without losers'. By the mid-1990s the reform coalition was sufficiently powerful and the case for reform was sufficiently obvious: deeper reform on many fronts – involving losers as well as gainers – was now possible.

By these means China became a so-called 'developmental state'. The term denotes a state which accords overwhelming priority to the achievement of rapid economic growth and adopts policies which are successful in achieving that objective. In China's case the developmental state arose for the need to restore and maintain political support and perceptions of political legitimacy.

The growth rate of GDP averaged 10% per annum over three decades. The proximate causes of China's outstanding growth performance were examined in Knight and Ding (2012). Suffice to say here that rapid capital accumulation, conditional convergence from a low base, and drastic sectoral change were found to be important. High physical investment (more than 40% of GDP in recent years) was crucial, both for its amount and its productivity. It could explain as much as 31% of the difference in growth rate between China and other developing countries, and conditional convergence (involving capital stock catch-up) another 47% (Knight and Ding, 2012: 80). Deeper investigation showed that investment defined as 'investment in innovation' and secondary and, especially, higher education enrolments were the most efficient types of investment. Three forms of structural change promoted efficiency and growth: the expansion of trade, the privatisation of production, and the transfer of labour out of agriculture.

The highlighted importance of capital accumulation for China's growth raises a deeper, underlying, question: why does China invest so much? The high rate of capital accumulation raised the danger that diminish returns to capital would set in and reduce its marginal product. However, the rate of return on capital remained reasonably high, and

¹¹ See chapters 4-7, estimating both cross-country and cross-province growth regressions, and using sophisticated model selection methods and panel data GMM techniques.

profitability remained promising enough to maintain high investment. This was facilitated by rapid TFP growth and the ready supply of surplus labour that could be combined with the growing capital stock

Entrepreneurial expectations of rapid economic growth were necessary for high investment. The developmental state was crucial. Incentives were provided at all levels of government: bureaucrats were rewarded for promoting investment, and business people could take investment decisions with confidence that supportive growth policies would be pursued and would be successful. Neither saving nor funds held back investment. Enterprises that were owned or controlled by government had access to a ready supply of bank loans at low rates of interest, and the non-state enterprises that were not linked to government were sufficiently profitable to be able to rely on their own retained profits. The fact that investment – mainly in high technology sectors and much of it embodying new technology – was so high in turn accelerated the growth of TFP. This is an example of the positive feedback effects that have kept the virtuous circle going.

7. Social instability as an adverse shock

There is an international literature on the effects on investment, or economic growth, of some of the factors that might cause social instability. For instance, Mauro (1995) analysed a cross-country data set which included proxies for corruption and found that corruption lowers private investment, thereby slowing down the rate of economic growth. This result was both statistically and economically significant. Alesina and Perotti (1996) tested the hypothesis that income inequality, by fuelling social discontent, increases socio-political instability, which in turn, by increasing uncertainty, reduces investment. Socio-political instability (proxied by measures of political unrest) and investment were treated as endogenous variables in their cross-country data set. The hypothesis was supported, and the inference was drawn that inequality retards the growth rate through its adverse effect on socio-political instability. Although China's degrees of corruption and inequality have not so far prevented rapid economic growth, it is plausible that, if they were to generate more social instability, they could slow down growth.

There is also a literature which directly relates instability to economic growth. Aisen and Veiga (2011) analyse a cross-country data set to examine the causal effect of political instability (as measured by indexes derived from principal components analysis of various indicators of political change) on growth and find that it is significantly negative. They identify the channels of transmission as weaker productivity growth and lower physical and human capital formation. Easterly et al. (2006) adduce cross-country evidence that a lack of social cohesion in society, as measured by income inequality and ethnic fractionalisation, retards economic growth through its effect on institutional quality.

There are various reasons why we might expect China's growth rate to decline as the economy matures. In addition, there can be shocks to the Chinese economy that might dislodge it from its current virtuous circle of economic growth. Economies are subject to unpredictable shocks, some internal to the economy and some external, some economic in nature and some social or political, and some based on current events and some on expectations about the future. In China's case, these might be financial, fiscal or external shocks, shocks arising from macroeconomic imbalances, and socio-political shocks that result, for instance, from social instability.

The hypothesis being advanced is that a severe adverse shock can start a cumulative process that ends a virtuous circle of growth and might even transform it into a vicious circle of stagnation. It is not a testable hypothesis unless and until the risk of a shock becomes a reality. The spectre to avoid is the experience of Japan, which moved from rapid growth up to the 1980s to slow growth since the 1980s. Several factors may have contributed to this reversal but an important one was the great financial bubble of the late 1980s and its subsequent collapse. Expectations of economic growth receded, investment confidence was lost, and in any case the undercapitalised banking system was unable to fund investment on the previous scale.

The underlying hypothesis is that a developing economy is characterised by two growth equilibria, one involving high investment and high growth and the other low investment and low growth. This perspective is different from that provided by neoclassical growth theory. A role is given to externalities. For instance, assume that the expected profitability, and thus investment, of each firm is raised by high investment in the economy as a whole. Moreover, if individual investment bears a non-linear relationship to the economy-wide anticipated investment rate – being insensitive at high and at low anticipated rates, there is the possibility of more than one self-fulfilling outcome. There can be one stable equilibrium in which investment is generally high and another stable equilibrium in which it is generally low (illustrated by Ray 1998:114-16).

Localised and uncoordinated cases of social instability do not pose a threat to expectations of continued rapid economic growth. However, should they become more widespread and coordinated, investor confidence might be shaken and aggregate investment might fall. That might set in motion a cumulative train of events. For instance, the external imbalances of the Chinese economy make it prone to asset bubbles through their effect on liquidity. A loss of investor confidence might cause an asset bubble to burst, in turn threatening the solvency of the banking system and the supply of funds for investment. The actual slower growth of the economy might itself deter investment, and it might also have a further adverse effect on social instability. Thus, there can be aggravating interaction among adverse shocks, and interaction between adverse shocks and economic growth.

The major case of social protest during the reform period was the Tiananmen Square incident of 1989. Despite the forceful repression that prevented the protest from spreading, it appeared to have a temporary adverse effect on the growth rate, partly because of the foreign reaction to the repression. Thus, growth of GDP was only 4% per annum in 1989 and again in 1990. However, it did not knock the Chinese economy out of its high growth trajectory beyond 1990.

A second example of an adverse shock is the drastic programme of reform of SOEs, discussed in section 4, that began in the late 1990s and continued for several years. This was forced on the leadership by the collapse in profitability and the rise in losses of many SOEs, which threatened both state revenues and investment and thus the sustainability of economic growth. Although the huge redundancies, the sharp rise in uncompensated unemployment, and the insecurity which the policy engendered, posed a threat of social instability, it was a threat that the leadership was willing to accept, and it proved to be manageable.

A third adverse shock for China was the world economic recession, starting in 2008. The recession had a dramatic effect on China's exports, which fell by 40% over two quarters. The collapse of employment in the export sector threatened to produce a wave of social discontent, albeit tempered by the return of migrant workers to their villages. The government responded promptly and powerfully to protect the economy from the economic recession that the export shock would otherwise create. It did so by means of expansionary monetary and fiscal policies. These included a huge infrastructure programme, funded by central government and by local governments using bank loans to companies set up for that purpose. There remained the risk of a future rise in non-performing loans, but the swift policy response to the fall in exports ensured that the danger of a collapse of entrepreneurial confidence was averted. Even in the worst two years (2008 and 2009) GDP growth averaged 9.4% per annum.

Labour unrest is another potential threat. China Labour Bulletin (2012) provides an account of growing worker protest in the first decade of the 21st century. Workers do not have the formal right to organise, to bargain, and to strike. However, the emerging shortage of labour and the rise of internet and mobile communication have made workers more demanding. The government subordination of the one official union, ACFTU, has not prevented the organization of increasingly effective collective protests by workers. These are most common in the private manufacturing sector. Many relate to existing rights and benefits, such as demands for wage arrears or against redundancies, but a growing number concern demands for additional rights and benefits, such as improved

pay or working conditions. Such protests have so far been localized but they might not remain so in future.

Thus, adverse shocks have so far failed to slow down China's rapid growth except very temporarily, and they might not do so in future. Nevertheless, the threat posed by social instability, both to the political order and to the growth rate, is probably growing as people's aspirations rise and society becomes more sophisticated, better informed, and more capable of coordinated action.

8. Concluding comments

The sort of social instability examined in this paper remains a far cry from a situation producing a political overturn. Goldstone et al. (2010) estimated a model of political instability for many countries, in which their dependent variable was the onset of civil war or political reversal. Their measure of regime type was the most powerful predictor, implying that political institutions are more important than economic conditions. Partial autocracy and partial democracy were the regime types most likely to produce political instability, especially if characterised by factionalism, rather than full democracy and full autocracy.

Although there are exceptions to this pattern, China is unlikely to be one of them. China is classified as a full autocracy, ethnic or regional factionalism is not significant, and its public security apparatus is pervasive. Moreover, Whyte (2010) concluded from his 2004 survey that the evidence was inconsistent with China's being a 'social volcano'. It is true that social instability of the sort that China has experienced could ultimately lead to political instability if social protest became infectious and coordinated, especially if it were inflamed by a consequent slowing of economic growth. However, our objective in this paper was the more limited one of considering the economic causes and consequences of social instability within the present political order in China.

Our argument can be summarised as follows. China's leadership shows much concern about social instability. The number of civil incidents' has increased rapidly in recent years, suggesting that social instability – albeit localised and uncoordinated – is on the rise. The government's main policy to maintain social stability has been to accord overriding policy priority to the achievement of rapid economic growth, although a second objective – promotion of a harmonious society – has recently been added. Despite China's remarkably rapid growth, the average life satisfaction has not risen over two decades. The explanation is to be found in people's concern about their relative income as well as their absolute income, and in the profound socioeconomic changes that have accompanied the growth of the economy. This failure of life satisfaction to rise should worry the leadership.

Microeconomic analysis suggests that unhappiness – and by implication social instability – is sensitive to expectations about future income growth, feelings of economic insecurity, perceptions of corruption, and economic inequality at least where it cannot be justified by productivity or effort. Moreover, many civil incidents are due to localised cases of procedural injustice, which reflect the lack of transparency and accountability in China's governance. An adverse shock which raised unemployment and dampened expectations of future growth could pose a threat to the virtuous circle of rapid growth that China now enjoys.

Our use of subjective well-being as a guide to social instability requires qualification. It is possible that people 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 sources of unhappiness are therefore potentially relevant. Thus, the level of social instability is likely to be governed not only by the rate of economic growth, the extent of income inequality, the degree of economic insecurity, the amount of corruption, and failings of governance but also by the perceived reasons and remedies for these conditions.

It was necessary to approach the economic causes of social instability only indirectly. To answer the questions posed in this paper we need sample surveys, like that of Whyte (2010), which probe perceptions of social dissatisfaction and their potential economic sources in this rapidly evolving society – so providing a dependent variable and possible explanatory variables for hypothesis testing. More generally, there is a case for further research – ideally interdisciplinary - on the role of social instability in the economic development process, in China and in other developing countries.

Two general points emerge at the level of theory. First, an underlying hypothesis of this paper is that there can be processes of cumulative causation at work - implying the presence of multiple equilibria that are only locally stable. One cumulative process concerns the ways in which social instability can escalate, and the other the ways in which the rate of economic growth can deteriorate. The scenario to guard against is one in which social instability harms entrepreneurial confidence and thus investment and growth, so generating further social instability, which beyond a tipping point becomes infectious. This process might be initiated by an event which causes the society to enter the second stage of Hirschman's 'tunnel effect', referred to above, that is, when enough people begin to see inequality not as a sign of available opportunities but as a sign of unequal opportunities and distributional injustice. Policy interventions may be required to stop such processes.

Second, insofar as policy concern for inequality arises from people's feelings and/or the effect of their feelings on social instability, there is a case for going beyond economists' conventional aggregate measures of inequality, in two ways. One form of decomposition would be to examine inequality relative to relevant reference groups. Another form would be to separate inequality into the part that is generally accepted (such as the rewards for productivity) and the part that is generally regarded as unjust (such as inequality of opportunities). These distinctions are easier to make conceptually than in practice, but they are worth exploring.

At the level of policy, part of China's huge foreign exchange reserves, now some \$3.2 trillion) (or about Y20,000 per capita, nearly double average household income per capita), can be viewed as a fire extinguisher, available to douse the flames of social unrest should it prove necessary. The reduction of social instability will involve sustaining the developmental state. It will probably require enhanced accountability and transparency in China's governance, such as might be achieved by an independent judiciary, an anti-corruption agency reporting directly to the central leadership, greater press freedom, and more democratic processes. Moreover, social instability will likely be curbed if government shows greater concern about economic inequality and insecurity, that is, if it further redirects policy objectives towards the creation of a harmonious society. Obvious candidates include reform of the *hukou* system, the strengthening and unification of social security, and the institutionalization of effective labour relations. These policies to deal with social instability are far better for the Chinese people and their leaders than the authoritarian alternatives of tighter repression or aggressive nationalism.

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