



# Income inequality, consumption, and social-status seeking

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## ABSTRACT

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Using the Chinese Urban Household Survey data between 1997 and 2006, we find that income inequality has a negative (positive) effect on household consumption net of education expenditures (savings) even after we control for household income. We argue that people save to improve their social status when social status is associated with pecuniary and non-pecuniary benefits. Rising income inequality can strengthen the incentives of status-seeking savings by increasing the benefit of improving status, and by enlarging the wealth level required for status upgrading. We also find that the negative effect of income inequality on consumption is stronger for poorer and younger people and that income inequality stimulates more education investment, which are consistent with the status-seeking hypothesis. *Journal of Comparative Economics* xxx (xx) (2011) xxx–xxx. School of Economics and Management, Tsinghua University, Beijing, 100084, PR China.

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## 1. Introduction

The Chinese consumption rate has been low and declining in the last two decades. According to the Chinese Urban Household Survey data, the average propensity to consume (net of education expenditures) of urban residents declined from 81.6% in 1997 to 74.7% in 2006.<sup>1</sup> Several explanations have been proposed for this phenomenon, including demographic changes (Kraay, 2000; Modigliani and Cao, 2004), high income growth and habit (Horioka and Wan, 2007), precautionary savings (Chamon and Prasad, 2010; Kuijs, 2006; Meng, 2003), change in the return rate of investment (Wen, 2009), and increasing sex ratio (Wei and Zhang, 2009).

In this paper, we explore another potential cause of declining consumption: rising inequality. The classical theory on the relationship between income inequality and the consumption rate emphasizes that if the propensity to consume decreases with income, then at the *macro* level, rising inequality could reduce the consumption rate. This “macro” reason for the inequality–consumption link is mechanically caused by the non-linear association between consumption and income at the micro, or household, level. If only the macro-mechanism is at work, then inequality should not affect consumption behavior at the household level once household income is well controlled for.

Empirical results drawn on the Chinese Urban Household Survey data for 1997–2006 show that income inequality within a reference group (i.e., families in the same province and same age group) has a negative effect on the household

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<sup>1</sup> The average propensity to consume (APC) is defined as living expense net of education expenses divided by disposable income. The change in the APC here is similar to that in Chamon and Prasad (2010).

consumption rate (net of education expenditures) after we control for household income. This implies the existence of mechanisms at work other than the “macro” mechanism. We explore several potential explanations for the observed inequality–consumption link, including rising housing prices, high income risks, high return to education, poor social security, and rising sex ratios. However, none of these can account for the observed inequality–consumption link.

We then propose and explore another potential explanation for the observed inequality–consumption link at the household level based on people’s desire to improve their social status. More specifically, people care about their social status, which is associated with pecuniary and non-pecuniary benefits. Social status often depends on a family’s rank in the wealth distribution or indicators such as educational attainment, which is closely associated with wealth when the credit market is imperfect. As a result, in order to ascend in the status hierarchy or keep the social status in the “Rat Race”, families try to accumulate wealth by increasing savings. When income inequality increases, the benefit gap between the high-status and low-status groups widens, which in turn strengthens the incentives of status-seeking savings. In contrast to the macro-mechanism, the status-seeking hypothesis implies that given household income, rising income inequality can still discourage (stimulate) household consumption (savings). Furthermore, rising income inequality also raises the entry wealth level for the high-status group, which means that more savings are needed for one to enter the high-status group.

The status-seeking theory also leads to further testable hypotheses. First, income inequality has a greater effect on consumption and savings for poorer and younger people because they have stronger incentives for moving up. Second, rising inequality should have a strong positive effect on families’ investment in education, which is an important indicator of social status. Third, inequality should have a negative effect on conspicuous (or unnecessary) consumption, and should have no impact on basic (or subsistence) consumption. Additional empirical analyses confirm these hypotheses. Finally, our results are robust to different measures of inequality.

The rapid increase in income inequality in China suggests that rising inequality is a very important reason for the low household consumption rate (net of education expenditures) in the country. According to World Bank (2005), China’s Gini coefficient has risen from 0.33 to 0.47 in two decades.<sup>2</sup> In our sample, the Gini coefficient in urban areas rose from 0.23 in 1997 to 0.29 in 2006, which implies a decline of the average propensity to consume (APC) by 2.08 percentage points, about 30.1% of the decline of the APC during the period.<sup>3</sup>

To the best of our knowledge, we are the first to find micro-evidence that rising inequality could be a reason for the declining consumption. Existing studies emphasize the link as “a macro-phenomena” and do not consider the micro-mechanism, that is, the effect of inequality on an individual household’s consumption or saving behavior given one’s income.<sup>4</sup> Alesina and Perotti (1996) propose a micro-mechanism of how income inequality could increase social tensions, thus increasing the risk of investment and reducing private saving rate. However, their empirical evidence is based on cross-country data, which are still at the macro-level. We are also among the first to show the importance of status seeking in increasing savings. The recent literature on economic growth demonstrates that the status-seeking saving motive can be beneficial for economic growth (Corneo and Jeanne, 2001; Futagamia and Shibatab, 1998; Gong and Zou, 2001; Pham, 2005), but there is little empirical micro-evidence to confirm the importance of the status-seeking motive.

The rest of the paper is organized as follows. The second section introduces our empirical framework. Section 3 describes the data and presents some descriptive statistics. Section 4 presents the empirical results and tests several potential explanations for the observed inequality–consumption link. Section 5 discusses how the status-seeking motive can lead to a direct effect of income inequality on household consumption and provide further tests for the status-seeking hypothesis. Section 6 presents results of robustness checks using other measures of inequality and consumption. Section 7 concludes.

## 2. Empirical models

To identify the effect of income inequality on consumption (saving) behavior, we estimate the following empirical model:

$$\ln(C) = \alpha + \beta * \ln(Y) + \gamma * \text{Gini} + \delta * X + \varepsilon, \quad (1)$$

where  $C$  is household consumption net of education expenditures,  $Y$  is household disposable income,<sup>5</sup> Gini is the Gini coefficient, and  $X$  includes all other covariates. The reason why we focus on consumption net of education expenditures is that education expenditures are usually considered an investment rather than consumption.<sup>6</sup>

Throughout the paper, consumption means all consumption expenses net of educational expenditures, unless otherwise specified.

<sup>2</sup> Moreover, there is a substantial variation across regions and time. For instance, our calculation illustrates that the Gini coefficient among urban residents in Beijing rose from 0.19 in 1997 to 0.25 in 2006, whereas the measurement in Zhejiang province changed from 0.23 to 0.32 in the same period.

<sup>3</sup> Our baseline estimation in column 6 of Table 1 indicates that when the Gini coefficient increases by 0.1, the APC declines by 3.46 percentage points. Therefore, a 0.06 increase of the Gini leads to 2.076 (=0.06 × 3.46) percentage points decrease in the APC, which accounts for 30.09 (=2.076/(81.6 – 74.7)) percent of the total decline of the APC between 1997 and 2006.

<sup>4</sup> For example, Musgrove (1980), Menchik and David (1983), Stoker (1986) and Dynan et al. (2004) suggest that due to the differences in the concavity of utility function, precautionary saving, or bequest motive, the saving rate of high-income families is higher than that of low-income families. Smith (2001) uses cross-country data to confirm that to the extent of credit market imperfection, income inequality has a robust positive effect on aggregate private saving rates. However, there are also some studies that find no effect of income distribution on the aggregate saving rate (Schmidt-Hebbel and Serven, 2000).

<sup>5</sup> Disposable income includes wages, capital gains, and transfers, excluding the social security contribution and income tax.

<sup>6</sup> We will also estimate the effect of inequality on education expenses, as well as total consumption that includes education expenditures.

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