



# Fairness and inequality tolerance: Evidence from the Life in Transition Survey



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## ABSTRACT

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This paper examines the link between inequality and individual well-being using household survey data from 27 transition economies, where income inequality increased considerably since 1989. A test of inequality aversion in individual preferences that draws on the Fehr and Schmidt (1999) specification of inequality aversion is proposed, and the difficulties of implementing it in a non-experimental setting are discussed. Estimates based on this model confirm aversion to inequality among individuals both in the pooled sample and separately among the EU and non-EU countries. The Gini index, on the other hand, is unable to capture this negative effect of inequality on well-being. Notably, inequality aversion is not intrinsic. Rather, it appears to be tied to a concern with the fairness of the institutions underlying the distribution of fortunes in society. The evidence is suggestive of inequality of opportunity driving attitudes toward overall inequality. *Journal of Comparative Economics* 42 (3) (2014) 590–608. The World Bank Group, 1818 H St, NW Washington, DC 20433, United States.

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## 1. Introduction

*"All societies are inegalitarian. But what is the relation between the inequalities in a society and the feelings of acquiescence or resentment to which they give rise?" (Runciman, 1972, 3).*

On October 15, 2011 *Occupy* protests that originated with the *Occupy Wall Street* movement in New York were planned in over 80 countries and 950 cities worldwide. These protests are perhaps the most vivid manifestation of the growing global concern with equity and inequality, also reflected in China's pledge to create a "harmonious society", or in the indicators underpinning European Union's "social inclusion agenda", or in the recommendation of the Sarkozy Commission (on the Measurement of Economic Performance and Social Progress) that "[q]uality-of-life indicators in all the dimensions covered should assess inequalities in a comprehensive way." (Stiglitz et al., 2009). This concern is driven in part by the oftentimes sharp increase in the gap between the rich and the poor over the past two decades in many OECD countries, in China,

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and in Eastern Europe. Yet, the mapping from a given statistical measure of inequality to preferences for redistribution, or to individual (social) welfare, and the importance of tradeoffs between the size of the pie and the inequality in its distribution will be influenced by the prevailing degree of inequality aversion in society.<sup>1</sup> The latter is the subject of this paper.

Some evidence of aversion to inequality can be inferred from the preferences for equity that have been observed in tightly controlled lab experiments, where individuals have been observed to have strong other-regarding preferences, to prefer equitable outcomes, and to engage in cooperation (Thaler, 1988; Camerer and Thaler, 1995; Fehr and Gächter, 1996; Fehr et al., 1997; see Fehr and Schmidt (2006) for a comprehensive review of the literature).

This paper investigates, rather, the degree of inequality aversion based on nationally representative household survey data. Evidence on this is more scarce and generally looks at associations between inequality, usually measured in terms of some statistical index like the Gini index, and subjective well-being using household survey data (Tomes, 1986; Clark, 2003; Alesina et al., 2004; Senik, 2004; Graham and Felton, 2006; Grosfeld and Senik, 2010). A negative association between inequality and well-being is viewed as indicative of inequality being a welfare-relevant consideration in the population. The motivation behind this line of research stems from the argument that aversion to inequality, by its nature, offers only a limited scope for revealed choice analysis, but more progress could be made by analysing expressed preferences. These studies reach mixed conclusions, inequality having either a positive, a negative, or no statistically discernible effect on individual well-being.

This paper suggests that if aversion to inequality is driven by social mobility considerations or by differences in status between self and relevant others, then aggregate statistical indices of inequality will be unable to capture in a meaningful way changes in status implicit in inequality dynamics. An alternative test of inequality aversion is adopted, that is better able to capture, I believe, status-driven aversion to inequality. The test builds on the model of inequality aversion proposed in the experimental literature by Fehr and Schmidt (1999), which is closely related to earlier work on relative deprivation by Yitzhaki (1979). The proposed specification, while intimately related to the Gini index, allows us to make progress in settings where aggregate measures of inequality are less appealing.

Several findings emerge from this study. First, individuals are found to exhibit aversion to inequality (in the sense of Fehr and Schmidt, 1999), and this result holds across a number of specifications, and also across regional subsets of countries. The Gini index, on the other hand, is unable to capture this negative effect of inequality on well-being. Second, inequality aversion does not appear to be intrinsic, but rather stems from a sense of fairness, as captured by opinions vis-a-vis the main determinants of success and economic need in society. As such, the findings are suggestive of inequality of opportunity being the factor that is driving the individuals' responses to economic inequality.

Section 2 reviews existing findings on inequality and subjective well-being, discusses the proposed methodology and addresses some of the difficulties of testing for inequality aversion with large household survey data. Section 3 describes the survey data employed in the empirical analysis. Section 4 presents the main findings, discusses the driving forces behind inequality aversion, and considers implications for social welfare. Section 5 concludes.

## 2. Social evaluation, inequality aversion, and reference groups

### 2.1. Existing literature

The primary aim of this paper is to test for inequality aversion using nationally-representative survey data. In the existing literature there are two types of studies that share this goal, at least to some degree. First, there are several recent studies that run experiments aimed at eliciting inequality averse preferences, where the study population goes beyond the usual student setting (Guth et al., 2007; Bellemare et al., 2008). Closer to the notion of social inequality, Pirttila and Uusitalo (2010), using a representative survey of Finnish people, present survey respondents with a 'leaky bucket' experiment in which they probe the respondent's willingness to have the tax schedule adjusted to effect a transfer from the top income decile to the bottom income decile. In addition, the authors also ask respondents to compare the Finnish wage distribution to alternative distributions with a higher mean and dispersion of income. While they find evidence in support of inequality averse preferences, the results also suggest differences between the two approaches – a large group of respondents who supported more narrow wage differences do not support costly progressive transfers.<sup>2</sup> The authors also find inequality aversion to be strongly associated with attitudes to increased tax progression, with increased unemployment insurance and unemployment assistance benefits, and with increased income support.

A somewhat larger, albeit still limited, literature looks at the association between individual well-being and statistical measures of income inequality.<sup>3</sup> The relevant question here is whether conditional on own income, and conditional on relative

<sup>1</sup> In the case of social welfare, the normative degree of inequality aversion in the social welfare function will also play a crucial role (Sen, 1997 provides a detailed discussion).

<sup>2</sup> The authors conclude that it is unclear why this is the case, but note that it is plausible that a smaller increase in the underlying latent preference for equality increases may trigger willingness to support an equal wage distribution, compared with the increase necessary to trigger support for costly transfers.

<sup>3</sup> This question is apart from the larger literature that examines whether relative status concerns, such as those embodied in the relation of someone's income to mean (or median) reference group income, or in someone's rank in the income distribution, are relevant for individual well-being (Clark and Oswald, 1996; McBride, 2001; Ravallion and Lokshin, 2002; Blanchflower and Oswald, 2004; Ferrer-i-Carbonell, 2005; Luttmer, 2005; Graham and Felton, 2006; see also Clark et al., 2008 for a recent review of the literature).

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