

5-2

Income Disparity in China and Its Policy Implications

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Executive Summary

China's economy has witnessed considerable achievements since economic reforms were initiated in 1978. Average overall gross domestic product (GDP) has grown approximately 9 percent annually during the past two decades. Coinciding with this rapid economic growth is a marked increase in income inequality. In recent years China has had alarmingly high income disparity levels and has become one of the countries with most unequal income distribution in the world.

Rising income inequality is considered one of the effects of the economic reforms. The move from egalitarianism to more market-based income determination has created both winners and losers within China's population. In urban areas, the restructuring of the state-owned enterprises and the development of a vibrant private industrial and service sector, with wages and employment determined entirely outside the old socialist labor bureaus, dramatically changed the returns to human capital and skill. This change led to highly unequal earnings and incomes among urban residents. In rural areas, the introduction of the household responsibility system and the establishment of off-farm employment opportunities based on township and village enterprises generated great differences in income among farmers and the nonfarm rural population.

Other policy measures implemented before and during the reform also contributed to income disparity in China. First, the heavy-industry-oriented development strategy, which aimed at promoting industrial growth within cities, greatly suppressed the agriculture sector and created a large urban-rural income gap. This gap was further widened during the reform period by a set of urban-biased fiscal and monetary policies. Second, a flawed sectoral and regional development policy has caused income disparity to rise among China's provinces. Third, the household registration system that limits labor mobility has aggravated the impacts of both sectoral- and regional-biased policies on spatial income disparity. Finally, the lack of social security has worsened income distribution in both urban and rural areas.

Large income disparities now exist between the urban and rural residents, between different regions, and among the urban and rural residents

themselves. Rising income disparity is a source of concern to the government because it causes widespread discontent and social protest. For long-term economic prosperity, the country should find a way to balance the policy that "let a few people get rich first" and the classical beliefs in egalitarianism. Income disparity in China has many dimensions, and only when the country is capable of tackling all of them can it develop a sustainable basis for continuing economic growth. A number of policy options are envisioned that would provide solutions to the problem.

Your assignment is to make policy recommendations to the Chinese government to help reduce income disparity in this country.

Background

Economic Growth and Income Inequality

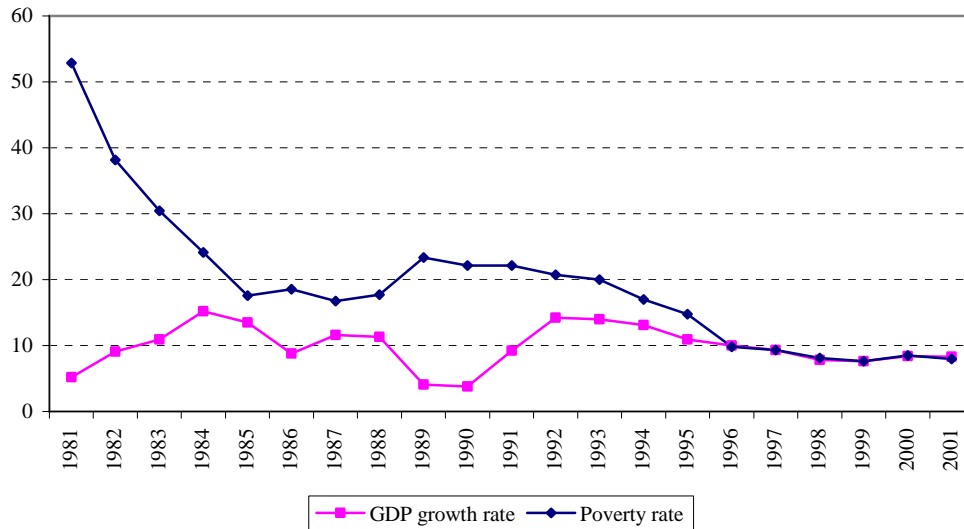
China's economy has witnessed considerable achievements in the past two decades and has become the second-largest economy in the world after the United States (in terms of GDP at purchasing power parity exchange rates). Starting in 1978, the Government of China began a process of liberalizing agriculture, trade, investment, and financial markets. The decentralization of government control and the creation of "special economic zones" to attract foreign investment led to considerable industrial growth, especially in light industries that produce consumer goods along China's coastal areas. Average overall GDP during the reform period grew approximately 9 percent annually, and the population living below the absolute poverty line has kept declining (Figure 1).¹ China has met the Millennium Development Goal of reducing the 1990 poverty incidence by half many years ahead of the 2015 target date and has been the trendsetter in regional and global poverty reduction.

¹ The absolute poverty line defined in Ravallion and Chen (2004) is 850 yuan (about US\$102 at the current exchange rate) a year for rural areas and 1,200 yuan (US\$145) a year for urban areas, both at 2002 prices.

Despite its progress, China's economy suffers from a number of social and economic problems. One of these problems is income disparity, which has been on the rise during the past two decades (Figure 2). According to a recent World Bank study by

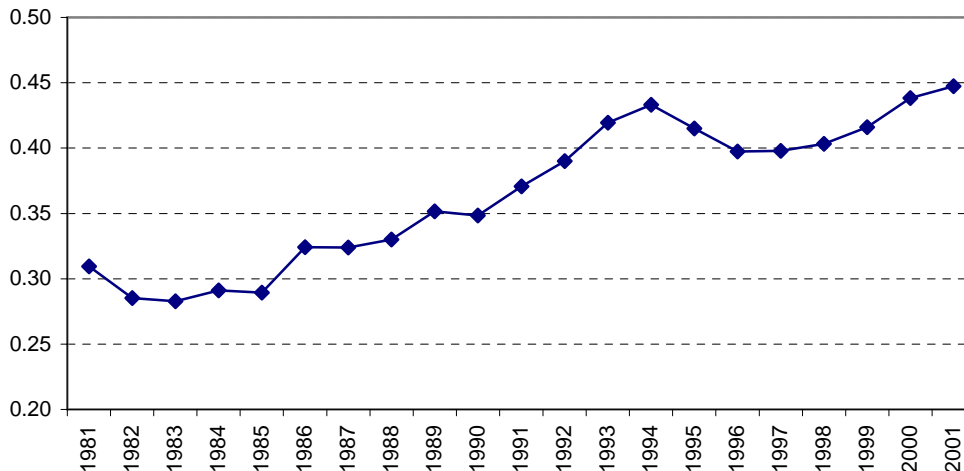
Ravallion and Chen (2004), the Gini coefficient, which measures income inequality within the Chinese population, reached almost 0.45 in 2001, a level many scholars consider alarmingly high.

Figure 1: GDP Growth and Poverty Rate in China (%)



Source: World Bank 2006; Ravallion and Chen 2004.

Figure 2: National Gini Index of Income Disparity for China, 1981–2001



Note: The Gini index is a measure of income inequality within a population. It takes a value between zero, when everyone has the same income, and one, when one person has all the income.

Source: Ravallion and Chen 2004.

Table 1: Income Shares of Different Income Groups in 2002 (percent)

Income Group	Income Share of Highest-Income Group			Income Share of Lowest-Income Group		
	National	Urban	Rural	National	Urban	Rural
1%	6.1	4.4	6.0			
5%	19.8	14.8	17.8	0.6	1.2	1.0
10%	31.9	24.4	28.1	1.7	3.0	2.5
25%	57.2	46.1	50.0	6.2	10.3	9.1
50%	81.0	71.8	74.5			

Source: UNDP 2005.

A survey conducted by the Economic Research Institute of the Chinese Academy of Social Sciences (as reported in the *China Human Development Report* [UNDP 2005]) reveals that in 2002 the top 1 percent of the population with the highest income owned 6.1 percent of the total income of the society (Table 1). The top 5 percent controlled nearly 20 percent of total income, and the top 10 percent controlled nearly 32 percent. In contrast, the poorest 5 percent earned 0.6 percent of the total, and the poorest 10 percent made less than 2 percent. These findings mean that the income of the richest 5 percent of the Chinese population was 33 times that of the poorest 5 percent, and the income of the richest 10 percent of residents was nearly 19 times that of the poorest 10 percent.

From Egalitarianism to “Letting a Few People Get Rich First”

Large income disparity in China has been a fairly recent phenomenon. For nearly three decades after the Communist regime started in 1949, income disparity was suppressed within its socialist egalitarian system. To minimize income inequality, the government adopted various policies on income distribution and redistribution that carried distinctive central planning and administrative features. In urban areas, factories, shops, and other means of production, as well as residential housing, were either state-owned or collectively owned. Workers' wages were centrally planned and administered, with the central government setting unified wage standards and scales. In rural areas, land and all other means of production were owned by people's communes and the production teams under them. The state monopolized the purchase and sale of key

agricultural products, implementing an even income distribution system among members of production teams or communes. As egalitarianism gained increasing popularity, differences between high- and low-income populations diminished in China. According to estimates by the National Bureau of Statistics of China, at the end of the 1970s the Gini coefficient for income inequality among Chinese residents was only about 0.16 (UNDP 2005).

Although egalitarianism had led to low income disparity, many people believed that the system was neither efficient nor equitable and led to economic stagnation. Since 1978 the government has embarked on a new economic development policy that has allowed a small number of people to get rich first and used them to stimulate enthusiasm and initiative in the rest of the population.² A major characteristic of the policy is that it explicitly recognizes the influence of entrepreneurial ability and human capital, acquired or natural, in determining economic returns. Welcomed by a large number of people, the policy quickly spread across the whole country. In urban areas, the reform of the state-owned enterprises (SOEs) and the development of a vibrant private industrial and service sector, with wage and employment determined entirely outside the old socialist labor bureaus, dramatically changed the returns to human capital and skill, leading to higher inequality of earnings and income.

² This idea was first presented by former Chinese leader Deng Xiaoping, who called on the country to allow some regions and people to get rich first so they could help others to achieve common prosperity.

In rural areas, the household responsibility system (HRS) immediately permitted households to retain a greater share of the returns to their own labor and entrepreneurial talent in managing their farms. Liberalization of farm-related activities and the establishment of family-run businesses provided another potential avenue for households to earn more than their neighbors. The establishment of township and village enterprises (TVEs), and the development of off-farm opportunities more generally, also provided households with a way to earn a living off the farm, potentially generating greater differences in income between farmers and the nonfarm rural population (Benjamin et al. 2005).³ As in the cities, rural industrialization and development provided rising returns to human capital and skills, leading to higher income inequality.

Profiles of Income Inequality

According to the neoclassical growth model, income convergence should occur as an economy grows—poor countries or regions tend to catch up with rich ones in terms of the level of per capita product or income. Although empirical findings from cross-country studies remain mixed, there is ample evidence for such convergence across regions within countries. The literature cites examples of the U.S. states, Japanese prefectures, and European regions and provides reasons that facilitate such convergence as relative homogeneity in technology, preferences, and institutions. Contrary to international experience, however, convergence in China has not been evident—somewhat puzzling given that market-oriented reforms are expected to facilitate resource flows that tend to equalize factor returns across sectors and regions. Large disparities still exist in various parts of China between urban and rural residents, between different regions, and among urban and rural residents themselves.

The urban–rural gap. Income disparity between urban and rural residents has been considered the biggest contributor to overall income inequality in China (Chang 2002). The urban-rural income gap has widened at an increasing rate since 1978, and in

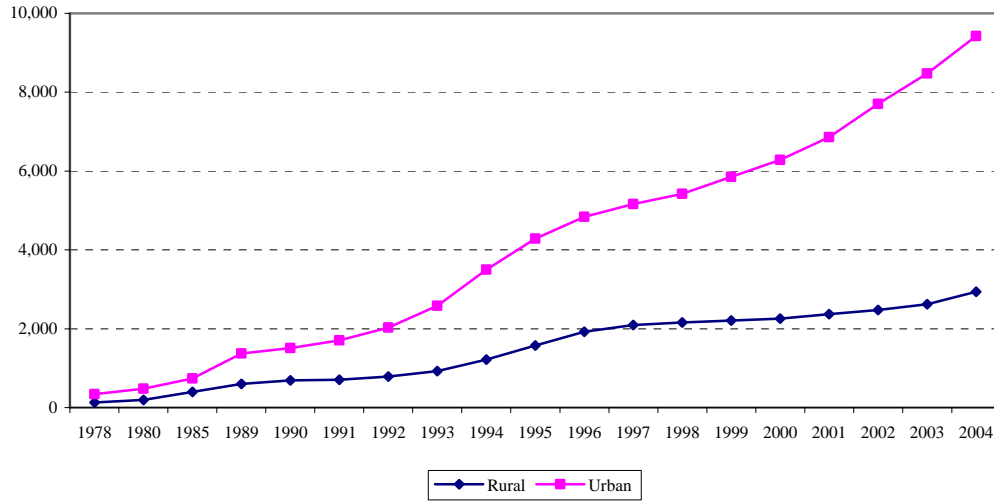
2004 rural income in China was only about 30 percent of urban income (Figure 3). Although most developing countries have a clear urban–rural income divide, urban-rural income inequality in China is much more serious than in other countries. This large income gap is the result of many factors, especially government policies that have been persistently urban biased.

Regional inequality. Large income differences exist among China's different regions, with residents in municipalities and provinces along the east coast earning much higher incomes than those in inland provinces. For example, per capita annual income in Shanghai (a coastal municipality) was 16,682.82 yuan in 2004, much higher than in provinces in north-east, central, and western China, none of which had per capita incomes exceeding 10,000 yuan. Although interregional inequality in China is caused by a number of factors, the most important is location. Location matters because the coastal regions have a much better agricultural production environment. They are closer to foreign markets, especially Hong Kong, Japan, Korea, and Taiwan; have much better infrastructure and human resources; and have been favorably affected by government policies (such as the opening-up policy) during the economic reform period.

Intraurban and intrarural inequality. In addition to spatial inequality, urban and rural dwellers also feel the income disparity among themselves. In 2001 the Gini coefficients were 0.32 and 0.37 in urban and rural areas, respectively—an increase of 75 percent and 48 percent over 1981 levels (Figure 4). Table 1 shows that income distribution was similarly skewed in both urban and rural areas. In 2002 the richest 1 percent of urban and rural residents earned about 4 percent and 6 percent of total urban and rural income; the richest 5 percent earned 15 percent and 18 percent, and the richest 10 percent earned 24 percent and 28 percent. In contrast, the poorest 5 percent of urban and rural residents earned 1.2 percent and 1.0 percent of the total, and the poorest 10 percent earned 3.0 percent and 2.5 percent. The income of the top 5 percent of income earners in 2004 was 12 times greater than that of the bottom 5 percent in urban areas and nearly 18 times in rural areas. Intraurban and intrarural inequality is primarily due to policy measures, especially those implemented during the reform period, that have changed people's income-earning capacity and opportunities.

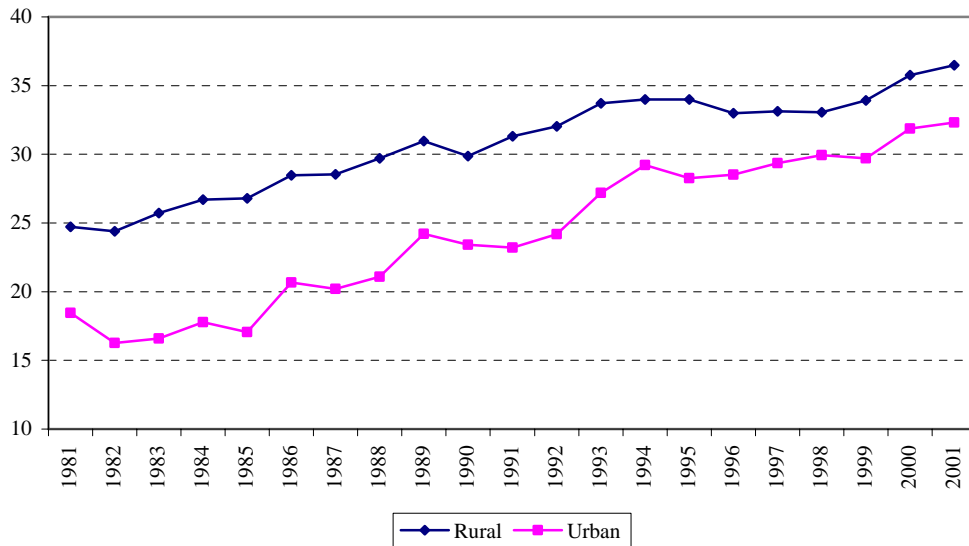
³ The impact of off-farm employment on rural income disparity in recent years is arguable. With a high percentage of the rural population now having access to off-farm employment, wages have become an income-inequality-reducing factor of intrarural household inequality (Zhu and Luo 2006).

Figure 3: Per Capita Annual Income of Chinese Urban and Rural Residents, 1978–2004 (yuan)



Source: China National Bureau of Statistics, various years.

Figure 4: Urban and Rural Gini Index of Income Disparity (%)



Source: China National Bureau of Statistics, various years.

Thus, by all counts, income disparity in China has reached high levels.⁴ Many economists are concerned that large income disparity could be detrimental to economic growth (Thorbecke 2007), and such a concern also abounds among policy makers and researchers within China. As early as 1996, Angang Hu, an influential scholar in China, warned that further increases in income disparity may lead to China's dissolution, as in the former Yugoslavia. Mainstream media like *The People's Daily* have frequently warned that further widening of income disparity may create serious social and political problems, generate nationalist conflicts, and negatively influence China's economic and social stability. Indeed, large income disparity has in recent years caused many social problems and been a serious challenge to the country's sustainable growth.

Policy Issues

Policy Bias against Agriculture

A prominent factor contributing to China's income disparity is the heavy-industry-oriented development strategy pursued vigorously by the government during the pre-reform era. To accelerate the pace of industrialization in cities, the state extracted massive amounts of resources from agriculture, mainly through the suppression of agricultural prices and restrictions on labor mobility. Despite some efforts to move industry toward the less-developed rural regions during the Great Leap Forward, the development strategy resulted in a large rural–urban income gap. Yang (2002) argues that the main mechanisms for enforcing this urban-biased development strategy were a “trinity of institutions” including the unified procurement and sale of agricultural commodities, the people's communes, and the household registration system (the *hukou* system).

Sectoral income differences declined in the beginning years of reform, owing in large part to the successful rural reforms that quickly liberalized agricultural markets, increased commodity prices, and raised farmers' earnings. But the decline was short-lived and was followed by a steady increase in rural-urban income disparity starting in the mid-

1980s. Government policy changes leading to reduced agricultural prices and rising fiscal and monetary transfers from the rural to the urban sector were important factors. These policy changes occurred during a time when the costs of living in cities were on the rise and the government was under substantial political pressure from the urban residents.⁵

From a pure development perspective, one might expect the urban-rural gap in China to narrow when the heavy industry emphasis and the urban bias are gradually abandoned as reforms proceed. First, a declining support for the industrial sector along with a rising one for the agricultural sector, and the end of urban food and housing subsidies would potentially serve to reduce the heavy urban bias of government expenditure. Second, the elimination of controls on many agricultural commodities, including the mandatory procurement of grains, would improve urban–rural terms of trade. Finally, the relaxation of China's residential registration system would encourage more labor migration from the countryside to cities, which would eventually equalize factor returns. But because reforms in China are taking effects only gradually, and more importantly, policy reversals sometimes occur, the extent to which these changes will matter for China's income distribution remains unclear.

Sectoral and Regional Development Strategy

A flawed sectoral development strategy has created large income disparities among provinces in China (Lin and Liu 2005). Since China was founded in 1949, the Great Leap Forward strategy had guided the development of capital-intensive heavy industries. For security reasons, many of these heavy industries were located in provinces in central and western China. The regional allocation of these high-priority industries was, however, inconsistent with the comparative advantage of those provinces, based on their factor endowments. Important factors for industrial production such as heavy equipment, financial and human capital, and advanced technology were non-existent. As a result, many enterprises in the high-priority industries were inefficient and required repeated government intervention to support and protect

⁴ According to UNDP (2005), of the 131 countries for which data are available, China ranks 90th in terms of the Gini coefficient for income distribution. Only 41 countries manifest higher income inequality than China.

⁵ In contrast, the large number and geographic dispersion of Chinese farmers made it difficult to organize and place collective pressure the government.

them.⁶ To maintain the functioning of these industries, the government depressed the prices of some natural resource-based inputs, which were produced in the areas where these industries were located. In theory, this practice is equivalent to a tax imposed on these regions. In the end, this strategy, instead of promoting industrialization, retarded the functions of the market, impeded capital accumulation, and hindered technology and productivity progress.

A biased regional development policy during the reform period also contributed to the widening regional income disparities. The economic reform initiated in 1978 allowed some people and some regions to get rich first. The sixth and seventh five-year plans (1981–1985, 1986–1990) strategically declared that more concentrated development efforts would be allocated to the most promising growth regions. Thus, many areas along China's eastern coast enjoyed significant increases in investment, especially foreign direct investment. Increased investments in development in the coastal regions have yielded significant gains, but the expected spillover effects for the rest of the country have not been evident. Inland provinces continue to be affected by regional protection and market segmentation. Studies have confirmed that the central government's policy of favoring investments in the eastern region has been the root cause of the lagging development and income in the central and western regions (see, for instance, Demurger et al. 2002; Fleisher and Chen 1997). In addition, these studies point out that unfavorable geographic conditions have also contributed to the lack of development in these regions.

Restrictions on Labor Migration

Sectorally and regionally biased policies would have limited impact on spatial income distribution if inputs were freely mobile across provinces or sectors. This is a standard implication of the neo-classical growth model with diminishing-return technology in which factor movements tend to equalize input returns across geographic locations and industries. Unfortunately, restrictions and obstacles to factor mobility prevail in China despite

⁶ To ensure the survival of these enterprises, the government created a market system with distorted factor and product prices and a resource allocation mechanism under direct administrative planning (Lin and Liu 2005).

progress with reform and the dominance of competitive forces in the final goods markets. The result is a modern urban sector with a competitive pool of labor and a populous rural agricultural sector with a huge number of surplus workers, estimated at 150 million. Those working in the urban modern sectors receive incomes equal to their marginal revenue product, but those in the rural agricultural sectors receive only their subsistence income as a result of their immobility.

Chang (2002) compares a college graduate in Shanghai, who can easily receive several job offers paying him 7,000 yuan a month to start, with a rural peasant, who can make barely 300 yuan a month. He argues that the pay to the college graduate is likely to increase, because as China further integrates with the world, its urban income will equalize with that in the rest of the world. The income of the rural peasant, however, is likely to remain at the subsistence level, because competition with other unskilled workers in the huge reservoir of surplus labor would make any increase in income impossible. There seems to be no easy way to reduce the income gap between the urban and rural sector as long as the unlimited labor supply in the latter sector cannot migrate out of it.

Institutions and policies that obstruct factor movements across regions or between rural and urban areas include explicit regulations on labor mobility (for example, the *hukou* system), preferential employment opportunities for local residents, poor housing markets, pension and health care arrangements, and high costs of child care and education for migrant families. These institutional factors reinforce the effects of sectorally and regionally biased policies on spatial disparity. Without labor migration, the reduction of the spatial income gap would depend solely on the relative growth rates, or development, of industrial and service sectors in different locations. To the extent that such development is concentrated in coastal areas or in cities because of pre-existing or continuing bias, the spatial income disparity is likely to persist.

Lack of Social Security

The reform of China's SOEs brought about problems related to social security that exacerbated income inequality within the cities. Before the reform, the SOEs relied on state funding to

provide social security to employees and their families. As the reform progressed, responsibility for providing social security gradually shifted to the SOEs, creating a substantial burden for these urban enterprises. In addition, the aging of the SOEs' employees raised the dependency ratio of retired people to active workers, making the burden even heavier. The government has attempted to reform the system by shifting responsibility for social security from the SOEs to the government through a new formal social security system. The implementation of these measures has been too slow, however, to keep up with the pace of reform. The result has been delayed payment or nonpayment of pension benefits to some retirees and pensioners and a widening income gap between pensioners and others in the cities.

Compared with urban areas, social security has been even more inadequate in rural areas. Before the reform, the main rural social security measures consisted of five guarantees (minimum guarantees for people unable to work and those with no income), health insurance (the Rural Cooperative Medical System, RCMS), and social relief for poverty caused by natural disasters. Most of these social security measures were of limited scale and were organized through people's communes, which were the basis for agricultural production, administration, and social services in rural areas. The majority of the rural households relied on self-help for social security purposes.

The economic reforms moved the production base from the collectives to the household by initiating HRS. This reform led to the disbandment of the communes in the 1980s, which weakened social security functions in rural areas. For instance, the RCMS scheme was weakened in most of the rural communities after the 1980s, and health insurance coverage fell to 9.5 percent of the rural population in 1998 (Liu 2004). Recently, the government has begun to pay attention to social security in rural areas, but rural social security still lags far behind the reforms in urban areas. The pension insurance system instituted in the early 1990s in rural areas provides a mechanism for social security, but because it depends heavily on personal savings accumulation, the system is essentially of a self-support nature. In sum, a private household in a rural area needs to take more responsibility for social security than a household in an urban area,

and in rural areas the responsibility has become greater since the reforms.

Stakeholders

Rural Residents

Economic reforms since 1978 have substantially improved the livelihoods of China's rural residents. The HRS provided substantial incentives to farmers, who have boosted their incomes by engaging in specialized agricultural activities such as animal husbandry, horticulture, and aquaculture, in addition to raising traditional crops. Furthermore, the TVEs contributed to the bulk of increased wage income earned by the rural nonfarm residents. Despite these improvements, however, the rise in income of rural residents has been markedly small when compared with that of urban areas (see Figure 3).

Rural residents are often deprived of in-kind subsidies that are enjoyed by residents in cities. These urban-oriented subsidies include low-cost capital for urban enterprises, low-cost housing for urban residents, funding to urban primary and middle schools, and generous pensions, health insurance, unemployment insurance, and minimum living allowances for urban workers. Although some rural residents who work for county or township governments have employer-covered health insurance, the quality and availability of medical personnel, clinics, and hospitals in urban areas far exceed those in rural areas. Therefore, if cash subsidies and other noncurrency benefits are taken into account, the welfare of rural residents lags significantly behind that of urban residents.

There is also a large income disparity among rural residents themselves. The widening intrarural income inequality after the reform is mainly due to the dis-equalizing role of nonfarm income and the slow growth in agricultural income (Tsui 1998).⁷ As

⁷ According to household survey data collected in 2002 by the Institute of Economics, Chinese Academy of Social Sciences (UNDP 2005), the wage income of rural households accounted for 29 percent of their total annual income. Because this income distribution was more unequal, its contribution to total income inequality was as high as 36 percent. In contrast, net farming income accounted for 39 percent of farmers' total income. But because the distribution of farming income was more equal, its contribution to total income inequality

more rural laborers move to nonfarm sectors—either by finding employment in rural enterprises, starting their own businesses, or migrating to the urban industrial, construction, or service sectors—the proportion of nonfarm income in rural income continues to rise.

Urban Residents

Income inequality in urban China began to increase in the mid-1980s, coinciding with the early stage of urban economic reforms. Various policy measures have had great impacts on the welfare of different urban residents. For instance, the government first implemented a policy of profit-sharing and decentralization by allowing local governments and state-owned enterprises to retain part of their revenues or profits. This measure created some successful enterprises that could pass profits to workers through bonuses and higher base wages, so that wage inequality rose across industrial sectors and across firms. It was also during this period of reform that food and housing subsidies were slashed. These important forms of in-kind income were likely very equally distributed, especially compared with the straight wages that replaced them.

The government subsequently reformed the state sector by privatizing small and medium-sized SOEs. Owing to the internal drive for more profits and external competitive pressures, many SOEs pursued structural reforms and resorted to cutting payrolls to improve efficiency. As a result, hundreds of thousands of urban workers were laid off. In addition, the SOEs tightened their pension programs, which negatively affected the retirees. Because of the lagging reform of the social security system, urban poverty loomed large. On the one hand, urban areas had booming economies and more opportunities to earn high incomes, especially for elite groups and the young generation who profited from their political and economic power and for a small number of people who took advantage of loopholes in the system. On the other hand, incomes declined for the unemployed, the retired, and the laid-off workers.

ity was just 27 percent. Therefore, the widening of rural income inequality is more closely linked to the development of nonfarm activities in the rural economy.

Residents in Different Regions

Strict central planning and restrictions on migration between regions have created serious disparities in income among residents in different regions of China. The central government implemented a biased reform from the beginning by designating four cities in the coastal provinces of Guangdong and Fujian as “special economic zones” (SEZs). These SEZs acquired considerable autonomy, enjoyed superior tax treatment, and received preferential resource allocations. Over time the policy was extended to all coastal regions, which consequently saw rapid economic growth and a widening development gap with interior regions. Although many cities in the interior were opened in 1994, the time lag may have put the noncoastal provinces at a significant disadvantage for attracting investment and generating growth.

Throughout the 1980s and 1990s, the coastal provinces attracted disproportionately high shares of domestic and foreign investments and international trade and became the cradle of urban and rural enterprises, which have been the driving force behind China’s income growth. Comparing annual incomes in some high-income provinces such as Jiangsu and Guangdong, both of which are in the coastal region, with those in Ningxia, Zhejiang and Qinghai, which have the lowest income level in the western region, reveals an enormous difference. In 2004 per capita annual income of Zhejiang (14,546.38 yuan), the richest province on the east coast, more than doubled that of Ningxia (7,217.87 yuan), the poorest province in the west. In a study that examined income inequality by assessing the relative contribution of inland–coastal disparity and urban-rural disparity to overall regional inequality, Kanbur and Zhang (1999) point out that the former has been much more significant than the latter. It should be noted that the inland provinces in western China consist of 11 provinces and autonomous regions, accounting for 56 percent of China’s total surface area and 23 percent of its population. Residents in these provinces include most of China’s ethnic minorities.

The Government

The government’s development policy during the reform period set overall economic growth as the first priority, even if this goal sacrificed some equality of income distribution and opportunity. Some argue that the policy is justified by the

Pareto criterion because low-income people can also benefit from economic growth to some extent through spillover effects. Renard (2002) argues that the spillover effects can come from three sources: (1) demand-side externalities if investors in other provinces think they can sell their output to the province; (2) trade externalities because transaction costs decrease as trade becomes more important, so the growth of trade in the coastal provinces may benefit the inland provinces; and (3) supply-side externalities because of the diffusion of technological knowledge and managerial skills. In addition, the classical economic view holds that an increase in income disparity is normal at an early stage of a country's economic development and that when the economy grows and per capita income reaches a certain minimum level, inequality will decrease.⁸

However, a continued increase in income disparity could obstruct a nation's economic growth. Thorbecke (2007) illustrates various channels through which inequality can lead to lowered economic growth. The detrimental effect of income disparity is more likely to occur in a country like China because of its cultural and ideological legacy of decades of socialism. Studies have shown that the Chinese population has low tolerance for income inequality. For example, China's Gini coefficient for income distribution is close to that of the United States, but only 65 percent of Americans judge income inequality as too great, compared with 95 percent of Chinese (UNDP, 2005). Although people's subjective judgments about social equity may not be based on objective facts, these judgments can influence people's behavior. In fact, in recent years the widening income gap between China's rich and poor has been a leading cause of the country's social problems, including rising crime rates in cities and frequent riots in rural and poor regions. The diffusion of political and social instability can lead to greater uncertainty and unproductive rent-seeking activities which discourage investments and entrepreneurship and eventually choke growth.

Thus, the government is facing a trade-off between efficiency gains from market-oriented reforms and problems associated with worsening income

distribution. For long-term economic prosperity, the government should balance the policy of "letting a few people get rich first" and the classical beliefs in egalitarianism. It needs to determine an "optimal" degree of equality (or inequality) that would achieve the twin goal of fair society and the incentives and rewards required for growth. However this is not an easy task.

Policy Options

The rising income disparity in China is a source of concern to the government, as it causes widespread discontent and social protest. Chang (2002) argues that the disparity level is likely to remain high in the coming years and that there is no effective way to reduce the Gini coefficient or other inequality distribution measures in the short run. He points out, however, that increased urbanization will help alleviate income disparity in the long run. From a different perspective, Yang (2002) suggests that a gradual removal of sectoral and regional biases in institutions and policies would help reduce disparity in China. The following are policy options that the government can choose from.⁹ This list is not intended to be exhaustive; other options may exist that will provide equally good or even better solutions to the problem.

Income Transfer

If market mechanisms do not lead to more equality, the state could intervene through income transfer programs to help protect the poor against risk of fluctuations or shocks. The basic idea is fiscal federalism, in which the central government takes responsibility for regional macroeconomic stabilization (Renard 2002). Action can be taken through two channels. First, there can be a passive channel of interregional risk sharing with automatic fiscal stabilizers. In this case, an asymmetric shock induces automatic transfers between regions.

⁸ The theory originally developed by Kuznets (1955) states that economic inequality increases over time, then at a critical point begins to decrease.

⁹ In recent years the Chinese government has implemented a series of policy measures that directly aim at reducing income disparity. These measures include elimination of taxes and fees for farmers, agricultural subsidies, rural infrastructure investment, a development strategy for western China, an urban Di Bao program (a program that provides minimum cash support for low-income urban residents), a national health insurance program, and a broader and more redistributive national income tax system.

Second, there can be an active channel of risk sharing, in which the central government provides subsidies to regional governments to compensate for the negative effects of a crisis.

Chang (2002) warns that an ill-designed transfer payment scheme, even if well intended, could in the long run worsen rather than improve inequality. For example, an aggressive transfer payment scheme could tax the modern urban sector and then make a transfer payment to the rural peasants. Because of the huge size of surplus labor in rural areas, tax revenue from the relatively small modern urban sector can do little to increase the peasants' income. The tax can, however, damage the growth of the modern urban sector, thus dampening the economic growth of the entire country and the absorption of surplus labor in the long run. In the near future, a transfer program of limited scope that targets only those who fall below the poverty line—that is, people living at the subsistence level—would be better than a large-scale program aimed at reducing nationwide disparity.

Regional Development Strategy

To reduce regional income inequality and its possible effects on growth and political stability, China might adopt a clear regional development strategy that favors the disadvantaged areas. Recent efforts to strengthen economic development in the western region show that the government has been aware of the inequality problem and is now moving to tackle this issue. In 2000 the government launched the Western Development Strategy (*Xibu Da Kaifa*) to accelerate economic growth and speed up the development of the country's western region. In the future, it is important that the country expand the strategy to cover other lagging regions.

Nonstate Enterprises

As China further integrates with global markets, the SOEs face increasing pressure to adjust their production structures to China's comparative advantage, which may lead to more layoffs. The government could design policies to promote the development of private businesses to reduce the unemployment rate. Because most of the poor are located in lagging western China, where state-owned industries remain the major providers of jobs, the need to speed up development of non-

state enterprises to absorb jobs lost by SOEs is even more urgent. Lu (2002) confirms the equity-enhancing role of the private sector through its better resource allocation. He proposes stronger fiscal discipline on local governments' taxation and revenue collection to release more resources to private hands. In addition, the financial and banking sector should be reformed to improve financing for private enterprises and to make the allocation of investment resources market oriented.

Social Security

Establishing an effective social security system for the potentially vulnerable population in urban and rural areas is another policy option deserving attention. Since China established and improved its socialist market economy system in the mid-1980s, it has reformed the social security system practiced under the planned economy. A basic framework for a social security system has been set up corresponding to the market economy system, with the central and local governments sharing specific responsibilities. According to the white paper "China's Social Security and Its Policy" issued by the State Council in 2004, China's social security system now includes social insurance, social welfare, a special care and placement system, social relief, and housing services. As the core of the social security system, social insurance includes old-age insurance, unemployment insurance, medical insurance, work-related injury insurance, and maternity insurance. The reformed social security system has helped to equalize the distribution of unemployed and retired household members' income in urban areas. As the paper admitted, however, the beneficiaries of the current system are confined to urban areas, and establishing a sound social security system for the entire country is an extremely arduous task. Currently, social security benefits for rural migrants are low, and most of the rural population still has limited or no access to the new system.

Infrastructure

The abolition of the old welfare system has caused a rapid decrease in in-kind subsidies and a corresponding increase in out-of-pocket expenditures on education, health care, and housing for urban residents. This change makes the urban poor more vulnerable to sudden shocks and crises and less likely to develop human capital, reducing their

ability to catch up with the rich. In the long run the government should broaden poor people's access to basic education and health care by increasing infrastructure investments so that all can share the opportunities offered by the economic expansion. Building infrastructure is important for rural residents as well. Improving rural infrastructure and promoting rural off-farm activities may raise the incomes of rural dwellers and increase domestic demand, which could provide a needed vent if the extraordinary growth led by foreign demand were to fall in the future.

Labor Mobility

Labor mobility between sectors or regions is instrumental in alleviating spatial disparity and should therefore be encouraged. The institution most frequently blamed for blocking mobility is the household registration system, which denies rural residents the right to migrate to urban areas. Although some restrictions on rural-to-urban migration have been relaxed or abandoned in recent years, the household registration system has been modified only marginally and still plays a crucial role in blocking labor mobility between the urban and rural areas. Lu (2002) suggests that further reforms of the household registration system to facilitate rural-urban labor mobility will "kill two birds with one stone" by both enhancing efficiency and improving equity.

Urbanization

Because the major cause of income disparity in China is the urban-rural income gap, the most effective effort the government can make may be to accelerate urbanization. Chang (2002) points out that China's urbanization lags substantially behind the world standard, and reducing this lag alone can help 50 million peasants find jobs in cities, significantly reducing the numbers living in rural areas. He notes that this change alone might not reduce the measured Gini coefficient per se, but it would certainly make the country as a whole better off. The ultimate cure for the urban-rural income gap is absorbing all rural surplus labor in the urban modern sector, which is closely linked to the reform of the household registration system. According to Chang, this process may take more than a decade because of the huge number of surplus workers in the rural areas. Achieving this objective will require that the government promote and maintain rapid growth in the urban modern

sector, and as the urban modern sector expands relative to the rural sector, the urban-rural gap may continue to widen for a period of time. Therefore, to reduce income disparity in the long run, China will have to live with a rising income disparity in the short run.

Assignment

Your assignment is to make policy recommendations to the Chinese government to help reduce income disparity in this country.

Additional Readings

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