

# The Future of Income Inequality in China

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# Growing Inequality

- Economic inequality in China has been much studied because it has grown rapidly. What was once a fairly egalitarian society, in terms of measured income, is now among the more unequal in the world.
- UNDP's 2006 Human Development Report showed only 30 countries out of 177 with greater income inequality than China's .
- The 2008 HDR gives the most recently calculated Gini coefficients for China and seven of its Asian neighbors, with China the most unequal:

# Income Inequality in Asia

<u>Country</u>	<u>Year</u>	<u>Gini</u>
Japan	1993	21.9
Korea	1998	31.6
Vietnam	2004	34.4
India	2004-05	36.8
Sri Lanka	2002	40.2
Singapore	1998	42.5
Philippines	2003	44.5
<b>China</b>	<b>2004</b>	<b>46.9</b>

# Reasons for Concern with Inequality

- Equity
- Political and social stability
- Impact of Inequality on Poverty:
  - Elasticity of the poverty rate with respect to the Gini coefficient is almost 2.84 (Meng et al)
  - This almost as high as the negative income elasticity of poverty rate (3.1): i.e., equal proportionate increases in income and inequality will almost cancel each other out, leaving poverty unchanged.

# Benefits of Greater Equity

- Some of China's most pressing economic problems would be eased moving toward a less inegalitarian system that provides health, education, social security and other social services reliably to the entire population:
  - More jobs would be created per unit of GDP growth.
  - Chinese growth would be tied less closely to foreign demand as citizens would no longer have to save such high proportions of their incomes.
  - Even the trade imbalance with the US would likely benefit from the emergence of a Chinese population that felt freer to spend its money.

## More Benefits: Impact on Growth

- ‘inequality is harmful to growth no matter what time horizon ...is considered’ (Wan 2008)
- This is a positive, not a normative, conclusion.

# What Kind of Inequality is Important?

- In Zhejiang Province, poorer villagers have traded land for off-farm income. As a result:
- Inequality of land use and farm income has increased, but inequality of total income has fallen. (Forrest Zhang 2008)
- An example of the principle that markets are more likely to operate in an equalizing way when assets start out equally distributed.

# Two Prominent Dimensions of Inequality

- Urban-Rural and Regional
- In both cases inequality has grown over the entire period of reform and transformation
- The two types are linked:
  - Overall urban-rural inequality shaped by changes in urban-rural inequality within the three macro-regions (East, Center, West).
  - Massive rural-urban migration should act as equalizing force.

# Paradox of Migration?

- Despite two decades of massive rural-urban migration, the urban-rural gap still registered as greater than 3:1 in the early 2000's, extremely high by international comparative standards.
- This gap manifests itself in other dimensions, as well: life expectancy, literacy, morbidity, etc.
- Why didn't it shrink?

# 1. Measurement Problems: correcting for regional prices

- First, adjusting for “cost of living” differences among the provinces reduces the urban-rural gap by 28 percent in 1995 and by 29 percent in 2002, and essentially eliminates its increase between the two years (Sicular et al).
- However, the absolute gap between urban and rural incomes grows by 64 percent in constant prices. Thus the urban-rural gap continues to grow in absolute if not in relative terms.

## 2. Including Rural-Urban Migrants




- Adding migrants to urban population reduces the gap 7 percent from its price adjusted 2002 value without migrants.
- Together, these two adjustments reduce the urban-rural gap by one-third, bringing it from 3.18 to 2.12 in 2002.
- Still at the high end of Asian countries but is less out of line with comparative international experience and it eliminates the improbable story that after decades of hyper-migration China is still an extreme outlier in its urban-rural income gap.

# Ratio of Urban to Rural Household Disposable Income, 2002, Adjusting for Regional Price Differences and Migrants in Urban Population

	<u>Ratio,</u> <u>Urban-to-Rural</u> <u>Income</u>
Unadjusted for regional price differences	<b>3.18</b>
PPP (adjusted for regional price differences)	<b>2.27</b>
PPP, and migrants included in urban population	<b>2.12</b>

- Source: Sicular et al (2008)

# A Link between Regional and Urban-Rural Inequality: Urban-Rural Gap by Region, and Direction of Change, 1995-2002 - A Centrifugal Story!

<i>Region</i>	<i>Ratio of urban to rural income</i>	<i>Direction of Change 1995-2002</i>
East	1.89	
Center	2.29	
West	3.49	

# Regional Variations in Urban Rural Gap

- The urban-rural gap in 2002 was responsible for over **half of total income inequality in the west**, over **one-third in the central region** and less than a **quarter in the east**.
- Thus, one key to reducing the gap for China as a whole is to **reverse this centrifugal tendency among regions**.

# Regional Inequality

## Disagreements over causes

- Natural response of market forces to unequal geographic characteristics?
- Wrong development strategy (“comparative advantage defying”) in the interior provinces (Lin)
- Wrong development strategy of central government (“coastal development strategy”)

# Inequality is Policy Dependent

- But common agreement that inequality, either regional or urban-rural, is not inevitable, but is influenced by policy and can be ameliorated by policy.
- Naughton: Support market forces favoring interior development with appropriate public investment.
- Khan-Riskin: decreasing regressiveness of net taxes, housing income helped reduce inequality.
- Justin Lin: Move to “CAF” strategy
- CHDR 2005: Relax *hukou*, unify labor market, invest more in public education and health, etc.

# Inequality a Target of Chinese Policy

- New development paradigm emphasizes building a “Harmonious Society” with more balanced development across regions and sectors.
- Government has substantially increased its commitment to pro-poor, pro-rural programs.

# Balanced Growth

- Leadership committed to “rebalancing” economic growth:
  - From *investment* and *export-led* growth to growth based on *domestic consumption*.
- Implication: reduced inequality, especially between export-dependent coastal provinces and inland regions.

# Inequality-Reducing Accomplishments

- Substantial reduction in regressiveness of net taxes in rural China between 1995 and 2002; reduction & elimination of agricultural tax, 2004-2007
- 250% increase in wage income exempt from income tax, 2006-2008
- Government encouragement of faster increases in local minimum wages
- 80% increase in government spending on health, education, social security and unemployment programs, 2004-2007.

# Modesty of Inequality-Reducing Changes

- Slowness of growth of safety net, social insurance
  - 18% of labor force covered by pension, end 2006
  - 14.5% covered by unemployment insurance
  - 13.3% covered by workers compensation
- Cuts in taxes on rural and urban incomes from 2004 and increased minimum wage levels had only small impact on household disposable income (Lardy)

# Reasons for Failures

- “The resource allocation decisions...are still made on the same basis; the incentive structure rewards the same types of behavior...; and the opportunities for rapid development were still enticing... Given that the basics of the high investment growth pattern were still in place, the early and modest efforts toward a more “balanced” ...society were simply swamped by a cyclical intensification of the old pattern.” (Naughton, 2008)

# Related: Weak Public Finance and Governance System

- “the central government faces significant difficulties in implementing social policies through the present system of delegated governance” and must first accomplish the following reforms:
  - “clarifying ... responsibilities for each level of government and for service providers,
  - ensuring adequate financing,
  - building a robust information reporting system, and
  - creating mechanisms for effectively enforcing responsibilities. ” (Wong)

# Fear vs. Inertia

- Until very recently, the future of inequality in China depended on whether fear of instability would be sufficient to goad the government into transforming public policy institutions into effective implementers of balanced and redistributive policies.
- Pessimists, like Christine Wong, could point to a “broken intergovernmental fiscal system that is unable to support national policy implementation.”
- Optimists could point to progress in constructing a social safety net, committing to free universal primary education, and launching an apparently serious reform of health care.

# Impact of Global Crisis

- The global crisis has changed this tradeoff by injecting the danger of stagnation into the picture as a rival source of potential instability.
- Crisis weakens (destroys?) the old model of export-led growth, thus favoring a new approach.
- But it also changes the relative priorities of rapid growth vs. rebalancing the economy – in favor of growth.
- This strengthens old structural incentives that put investment-led growth first.

# Melting Away of Growth Premium

- Easier to redistribute marginally out of a large growth premium. No losers.
  - Equalizing moves of early 2000s came at a time of extraordinarily fast growth.
  - Yet total expenditures on health, education, social security and unemployment by all levels of government, as a share of GDP, grew by only 0.5% between 2002 and 2007.
    - (1) Slow progress by provincial governments, responsible for 90% of social spending.
    - (2) GDP was growing by over 10% per year.

# Zero Sum Game

- Thus, even when growth exceeded 10% per year, there was only very modest growth in coverage of social insurance programs.
- When growth premium shrinks or disappears, such redistribution becomes zero sum game and resistance mounts. Can progressive change continue in these conditions?

# China's Economic Stimulus Plan

- The November 2008 plan is large and bold
- Several parts of it are potentially inequality-reducing:
  - Public housing focusing on urban low-rent units and renovation of rural housing
  - Rural infrastructure investment: water supply, conservation, irrigation, roads, power grid.
  - Health & Education: improving local clinics, renovating inland schools
  - Public transport
  - Increased Minimum Living Allowance payments
  - Increased grain procurement prices, farm subsidies

# The New Deal

- There are potentially both positive and negative feedbacks to the “Harmonious Society” plan from the global crisis. Which will prevail?
- In 1932, Hoover orthodoxy had been discredited and New Deal policies had no real competition. Yet it took great leadership to overcome conservative resistance to the New Deal
- Even so, the politically feasible proved economically insufficient.

# New Deal or Return to Orthodoxy for China?

- In China today, economic orthodoxy means export and investment-led growth, which has compiled an unprecedented record of fostering growth and pushing back the wolves of unemployment and instability, even if at a high cost (environmental, health, inequality).
- With crisis threatening to magnify these threats again, the temptation will be strong to turn back to that orthodoxy, modified to substitute even more domestic investment for shrinking exports.

- The benefits of “rebalancing,” replacing investment with consumption, expanding social benefits programs, strengthening the safety net, improving rural education and health care, may look less compelling next to the immediate need to create jobs.

- It will take leadership to overcome this temptation and risk undertaking a Chinese New Deal.
- Rebalancing and “harmonious society” policies could reduce income inequality in China to levels more normal in that region of the world.
- Such an outcome would also make China less vulnerable to future global crises like the current one.

# Crystal Ball?

- If the government opts for a short-run strategy of creating jobs via the familiar path of investment-led growth, then trend toward widening inequality would continue.
- I would guess that this is the most likely outcome – and hope to be wrong....