

Policy Brief

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Overview

The slowdown and in some years reversal of poverty reduction in China forcefully demonstrates that growth is not sufficient for combating poverty even if that growth is of unprecedented magnitude. Policy initiatives should take into consideration inequality, especially urban-rural disparity. This Policy Brief provides a summary of the research findings from UNU-WIDER's project on Inequality and Poverty in China. It also offers policy recommendations for tackling the poverty-growth-inequality inter-relationships in the short- and long-run. In particular, it is suggested that the only long-run policy option for the Chinese government is to encourage urbanization.

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Poverty Reduction in China: Is High Growth Enough?

SHOULD GROWTH OR INEQUALITY BE PRIORITIZED IN THE DESIGN AND EXECUTION OF DEVELOPMENT POLICIES? An oft cited paper by Dollar and Kraay of the World Bank advocates growth as the primary objective of development. Opponents argue that growth may not be pro-poor, thus growth alone is insufficient for poverty reduction—the ultimate goal of development. They instead emphasize redistribution as an important policy instrument. From a practical point of view, most policies involve trade-offs between efficiency (i.e., growth) and equity, at least in the short-run. With this in mind, development strategists and policymakers face the challenge or dilemma: what should be prioritized in the design and execution of development policies?

To further complicate the matter, many channels exist through which growth may affect distribution in different ways. Meanwhile, growth and poverty outlooks depend on the current level and dynamics of inequality. The emerging literature on the inequality-growth nexus has produced conflicting findings. Clearly, more research is needed in order to better understand the poverty-growth-inequality (PGI) triangle, which states that any poverty change can be expressed as a mathematical function of growth and the variation in inequality.

Post-reform China represents a good opportunity for studying the PGI triangle. While growth in China has been hailed as a miracle and its impact on poverty is well-recognized, the efficiency-emphasizing but equity-ignoring development experience has led to the fast rise of inequality along every dimension and must have contributed to the emergence of urban poverty and to the slowdown, even reversal, of poverty reduction in China.

Needless to say, exploring the PGI triangle in China is important for a number of reasons. First, the alarmingly high level of inequality poses a threat to the sustainability of growth as it undermines China's social and political stability, to say the least. Second, China's growth prospects and inequality-related domestic demand have profound implications for other economies, particularly in terms of China's

About the Author



Guanghua Wan is a Senior Research Fellow and project director at UNU-WIDER. An honorary professor of some leading universities in China, and a prolific researcher with over 50 analytical papers in top-class journals, he is a pioneer in developing the regression-based techniques for inequality and poverty decomposition.

huge trade surplus and ever increasing trade disputes. Finally, China's PGI profile determines the global inequality and poverty scene and insights from this profile may help international organizations and other national governments in tackling poverty, growth, and inequality.

Despite the importance of PGI linkages in China, only limited literature exists, focusing on poverty or growth or inequality separately. In what follows, we summarize major findings from the UNU-WIDER project on 'Inequality and Poverty in China' and provide policy recommendations for addressing the PGI triangle.

The PGI Triangle in China

Despite the fact that China began its remarkable growth by dismantling the egalitarian system, it is found that inequality is harmful to growth no matter what time horizon (short-, medium-, or long-run) is considered, and that the growth–inequality relationship is non-linear. Conversely, growth and inequality are positively correlated, implying further rises in income inequality in China unless concerted policy interventions are instituted. Both income growth and

more prevalent in inland China. The most important contributors to the poverty difference between inland and coastal China are inequality and domestic capital. Consequently, policy measures to assist poor regions in accumulating physical capital and tackling within-region inequality are urgently needed. Moreover, globalization is found to work alongside and interacts with other poverty determinants. Therefore, the challenge is to keep close tabs on the circumstances at the local level and to ensure that globalization serves the poor.

Surprisingly, fiscal transfers in China are largely regressive. At the provincial level they exert little or regressive effects on inequality. At the household level, residents in the central and western regions received less social benefits of all types than those in the eastern regions. Also, important in-kind benefits—namely health and food in 1988 and education in 2002—were positively related to pre-tax pre-transfer income. The working poor (the near-bottom income groups) have not only fared poorly in earnings but have also been left behind with respect to social benefits.

In designing development policies, a dilemma or challenge is: should growth or inequality be prioritized as the primary goal?

favourable distributional changes can explain China's remarkable achievement in combating poverty in rural areas in the first half of the 1990s. However, in the latter half of the 1990s, both rural and urban China suffered from rapidly rising inequality and stagnant income growth, leading to a slowdown in poverty reduction, and even to a reversal in the poverty trend.

As is well-known, poverty is much

Since growth has been positive throughout the post-reform era, the PGI triangle in China essentially hinges on the issue of inequality. It can be said that future reduction in poverty largely rests on the inequality trend. Although inequality has been rising along all dimensions in China, regional inequality is the pivotal component. Thus, it is crucial to identify fundamental determinants of regional

inequality as far as PGI in China is concerned.

Broadly speaking, China's regional inequality consists of two dimensions: the east–central–west divide and the urban–rural divide. The latter contributes a very large (over 70 per cent of the total) and increasing proportion to overall regional inequality. The fluctuations and increase in overall regional inequality, particularly since the early 1990s, is almost entirely attributable to the urban–rural gap. The east–central–west divide however only contributes some 30 per cent to total regional inequality and its contribution has been more or less stable since 1991, with the exception of 1996–98.

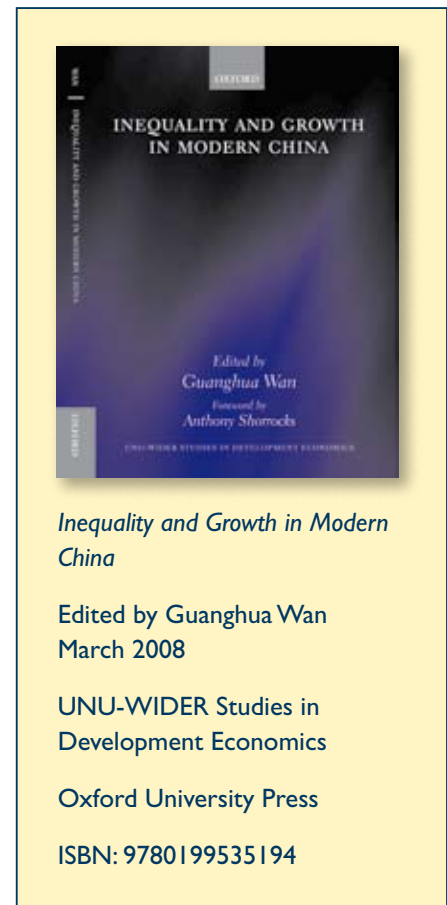
Regarding fundamental factors, globalization as represented by trade and foreign direct investment (FDI) variables is found to be among the most influential factors causing fast rises in regional inequality in China. The relative contributions of education, location, urbanization, and the

growth. Further, the increase in regional inequality from the mid-1960s to the mid-1970s is mainly due to the contribution of total factor productivity (TFP) overwhelming that of physical capital. The opposite is true for the 1980s. The increase in the 1990s is mainly driven by the skewed distribution of investment in favour of the richer coastal provinces reinforced by the increasing contribution of TFP.

Policy Recommendations

It is clear that growth alone is insufficient for achieving the ultimate development goal. If unprecedented growth in modern China is not enough to combat poverty, it is simply unrealistic to expect achievement of the Millennium Development Goals in any other country without emphasizing distribution issues.

To tackle the PGI triangle in China, it is essential to target the urban–rural gap rather than the coastal–inland disparity as a first priority. China could



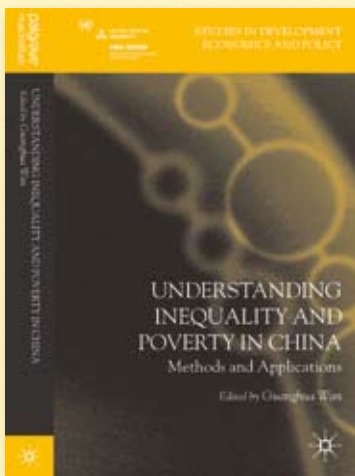
Miracle growth in China has not been sufficient for poverty reduction since the 1990s, due to inequality increase along all dimensions

dependency ratio to regional inequality have been declining although their absolute contributions have not. More interestingly, domestic capital is the largest and increasingly most important contributor to regional inequality. Uneven distributions of domestic capital, FDI, and trade account for almost 50 per cent of total regional inequality.

Not only is the stock of domestic capital important, capital is also less productive in less developed regions. While financial deepening helps promote economic growth in coastal China, this is not the case for inland regions where most financial indicators are insignificant in explaining

only cut its regional inequality by some 30 per cent if the east–central–west disparities were eliminated. On the other hand, a drop of over 50 per cent could be achieved by eliminating the urban–rural gap. Clearly, a rewarding move is for China to target the rural areas in the poor west and centre of the country.

It is worth mentioning that to tackle the two major dimensions of inequality in China, the urban–rural and coastal–inland divides, the Chinese government launched an ongoing campaign of ‘western development’ in 1999, and the recent campaign of ‘building a new socialist countryside’. Neither of these, however, is likely to work. The bare



Understanding Inequality and Poverty in China: Methods and Applications

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fact is that the rural sector takes up only slightly more than 10 per cent of national GDP with over 60 per cent of the national population. It is simply not rational and clearly infeasible, using carrots and/or sticks, to tackle urban–rural disparity. After all, on what grounds can government transfer more than half of urban GDP to the rural areas? And without bridging the urban–rural gap, how can the coastal–inland divide be resolved?

Short-run Solutions

Poverty and rising inequality can be alleviated by: (1) establishing and developing rural capital markets. Formal capital markets are essential for promoting capital formation in rural China. The gradual withdrawal of bank branches from rural China must be stopped or replaced by development (policy) banks. Policy support for investment in the poor regions is needed in terms of tax concessions and bank lending. In particular, further financial reforms are necessary in order to eliminate discrimination against small farmers and rural

quality of schooling in poor areas; (3) the promotion of trade and FDI in inland China. Policy biases that helped trade and FDI but which are gradually phasing out in coastal China should be implemented elsewhere. Successful implementation of these three policy recommendations will cut regional inequality by more than 50 per cent.

The Ultimate Long-run Solution

The inevitable and long-term solution lies in urbanization: by encouraging rural residents to permanently settle in urban China. In this context, abolishing the household registration system is only a necessary but not really sufficient condition for tackling the urban–rural gap. A criticism of this proposal is that the urban areas cannot absorb the huge surplus rural population, which could be in the order of 550 million people, particularly as far as employment is concerned. I beg to disagree.

The arithmetic is fairly straightforward. At present, an estimated 100–120 million migrants are already absorbed by the urban economy, except that they are labelled

The ultimate long-run solution to the poverty–growth–inequality triangle in China lies in moving 550 million rural residents into cities

activities. While various government entities and financial institutions are experimenting with micro-credit schemes, such a complementary scheme must be adjusted to cater for capital formation; (2) fiscal spending and redistribution being made progressive rather than regressive. All transfers can be conditional, geared towards physical capital formation and education of the young. In particular, public research and development (R&D) investment in agriculture must be increased to improve farming productivity, and special attention must be paid to the

as farmers. Their dependents largely rely on remittances from the migrants. As far as employment is concerned, shifting these dependents to urban China presents few challenges. Since migrants are almost all of working age (they typically leave children and the elderly behind mainly due to non-access to education, health, and other facilities), they represent some 100 million rural households or 400 million heads of population. Among the extra 300 million people, some 100 million are labourers who would need to find employment in the cities. However,

even without jobs, these new migrants can still survive without direct financial support from the government and they would certainly have a better quality of life in the cities than if they had stayed behind. Most importantly, as long as they are treated equally as urban residents in public education, their children and thus the migrant families would have a much brighter future.

Is it realistic for 100 million extra labourers to find jobs in the cities? The answer is yes; not least because the service sector in China lags behind the state of the overall economy. Settling the 400 million migrants permanently in urban China will stimulate the service sector, which is by its nature labour-intensive. How many jobs would be created remains unknown, if and when the service sector matches the development status of China. But the potential is huge, particularly considering that cities will double their current size after such an influx.

This leaves 150 million surplus population or less than 75 million surplus labourers in rural China. To settle these migrants over a period of 20 years is a mission only requiring the creation of three to four million jobs each year.

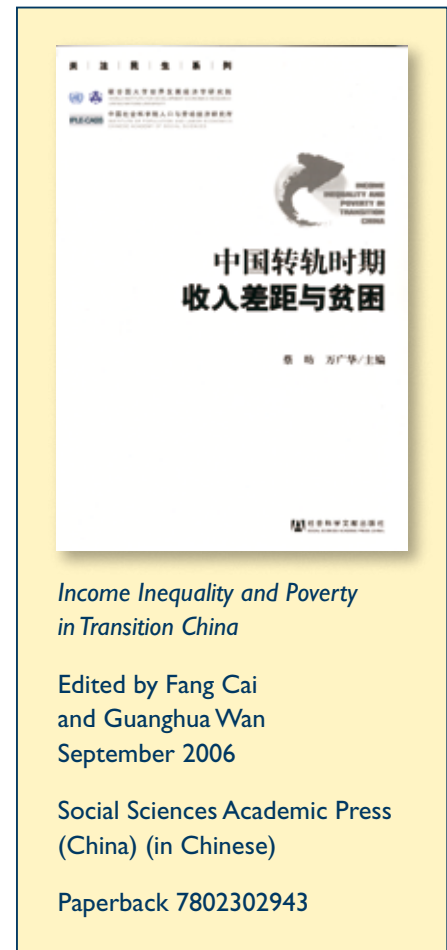
The migration of 550 million rural residents implies doubling the current size of existing cities. This is a worst-case scenario, without setting up new cities in inland areas, as suggested by some economists and strategists in China. The population of Shanghai net of migrants was almost 14 million in 2007. Under the worst-case scenario, simple extrapolation would increase this to 27 million around 2030. This is not so incredible. In relative terms it represents a mere 2 per cent of China's population. And the calls for a Shanghai of 50 million people are being voiced by leading economists from that city. They argue that many big cities around

the world such as Tokyo, London, and Mexico accommodate 20 per cent or more of their national population. In fact, the current population of Shanghai, including migrants, already reached 18.58 million in 2007.¹

It is pertinent to mention the debate about the urbanization strategy in China. One group encourages the formation and development of mega-cities. The other group prefers the growth of small and medium cities. The difference between the views is essentially a choice between a centralized system as in Japan or a decentralized system as in Germany. Critical issues that must be carefully addressed in this context include the economies of scale in urban development and agglomeration effects.

To minimize the social problems potentially associated with massive migration, a step by step procedure is necessary whereby migrants with long-term jobs or secure housing in urban areas should be given priority. Those with better education should also enjoy concessions. In fact, application for migration can be assessed using a scoring system, with demographic and other characteristics of all family members being taken into consideration. To ease fiscal pressure, new migrants may be provided with limited (phasing out) access to financial assistance in housing, education, health care, and other welfare provisions. Community colleges should also be set up in the cities to provide training and education to temporary and long-term migrants and their family members.

¹<http://politics.people.com.cn/GB/14562/6928395.html>



Endorsements

Inequality and Growth in Modern China, Oxford University Press

The chapters contained in this volume offer a comprehensive view of modern China's experience with the triangle of growth, inequality, and poverty. They collectively provide valuable insights for other developing countries in the pursuit of inclusive growth strategies. — **Xianbin Yao**, Director General, Regional and Sustainable Development Department, Asian Development Bank

Inequality in income and wealth, what causes it and how it affects the rest of economy, has become one of the key topics both in the economics literature and the popular press. This is because the last quarter century has witnessed a veritable exposition of inequality in almost all parts of the world. And perhaps nowhere has this exposition been as large as in China. Its impact there was 'softened' by remarkable economic growth. Yet as regional and class fissures, reminiscent of a long-gone era, reappear, the relationship between inequality and growth is rapidly becoming one of the top political issues in China. This book addresses different facets of China's inequality-growth relationship, and will be a useful reading for China specialists as well as for those interested in inequality and growth as such since China is the largest 'laboratory' where they can observe it. — **Branko Milanovic**, Lead Economist, World Bank Research Department

This volume of high quality research resulting from UNU-WIDER provides an essential reference for scholars and students worldwide in their research and studies on growth and income inequality in modern China. The editor, Dr Guanghua Wan, is one of the world's

most productive and authoritative experts on the Chinese economy. — **Shujie Yao**, Professor of Economics and Chinese Sustainable Development, and Head of the School of Contemporary Chinese Studies, University of Nottingham and Special Chair Professor of Economics, Xi'an Jiaotong University

The papers collected in this book come from leading scholars studying China's inequality issues. It is a timely book. Rising inequality in China is well known; less well known are the linkages between various aspects of China's economic growth strategy and inequality. This book offers fresh perspectives as well as solid evidence for a better understanding of these linkages. It is a valuable reference for scholars concerned with the relationship between economic growth and inequality as well as for students on China.

— **Yang Yao**, Deputy Director, China Center for Economic Research, Peking University

Over the past three decades, China has made huge strides in its battle against poverty as it has transformed into one of the most dynamic economies in the world. It will be harder for China to maintain its past rate of progress against poverty without addressing the problem of rising inequality. The book *Inequality and Growth in Modern China* provides a useful overall assessment about inequality in China, focus on inequality in view of the growing concerns with rising inequality, the cause and impacts of rising inequality, and its relation to overall growth and poverty reduction. It will not only help policy makers understand the inequality in China—but also be a useful pedagogical tool for Chinese and other researchers. — **Shaohua Chen**, Senior Statistician, Development Research Group, World Bank



Journal of Comparative Economics

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UNU-WIDER Symposium:
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Consequences of Rising
Inequality in China
Guest Editors: Guanghua Wan
and Xiaobo Zhang
Elsevier



The Review of Income and Wealth

Volume 53, Issue 1, March 2007
UNU-WIDER Special Issue:
Inequality and Poverty in China
Edited by Guanghua Wan
Blackwell

Understanding Inequality and Poverty in China: Methods and Applications, Palgrave Macmillan

The miraculous economic growth in China has, since the mid-1980s, been accompanied by rapidly rising inequality. This is slowing down poverty reduction and is tearing at China's social fabric. Understanding the causes and implications of this rising inequality is thus critical. This volume provides the most up to date and thorough empirical analyses of these crucial issues by leading China scholars. It should be required reading for China scholars as well as policy-makers trying to address this worrying rise in inequality.

— **Stephan Klasen**, Professor of Economics, University of Göttingen; Director, Courant Center 'Poverty, Equity, and Growth in Developing and Transition Countries'; Editor, *The Review of Income and Wealth*

The book gathers a fascinating collection of articles on various aspects of income inequality and poverty in China. This is applied economics at its best, with essential policy implications for the fastest growing economy in the world for the past quarter of a century.

— **Jacques Silber**, Bar-Ilan University; Founder and former Editor-in-Chief of the *Journal of Economic Inequality*

Author's recent UNU-WIDER publications on Inequality and Poverty in China

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'Rising Inequality in China': pp. 651–3 (with Zhang Xiaobo)

'The Inequality–Growth Nexus in the Short Run and Long Run, Empirical Evidence from China': pp. 654–67 (with Lu Ming and Chen Zhao)

'The Impact of Growth and Inequality on Rural Poverty': pp. 694–712 (with Zhang Yin).

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'Understanding Regional Poverty and Inequality Trends in China: Methodological and Empirical Issues': pp. 25–34

'Globalization and Regional Inequality in China: Evidence from within China': pp. 35–59 (with Lu Ming and Chen Zhao)

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'Poverty Accounting by Factor Components: With an Empirical Illustration Using Rural Chinese Data': pp. 184–204.

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The World Institute for Development Economics Research (WIDER) was established by the United Nations University (UNU) as its first research and training centre and started work in Helsinki, Finland in 1985. The Institute undertakes applied research and policy analysis on structural changes affecting the developing and transitional economies, provides a forum for the advocacy of policies leading to robust, equitable, and environmentally sustainable growth, and promotes capacity strengthening and training in the field of economic and social policy making. Work is carried out by staff researchers and visiting scholars in Helsinki and through networks of collaborating scholars and institutions around the world.

INSIDE: Policy Brief

“Poverty Reduction in China: Is High Growth Enough?”

A summary of project findings, including specific policy recommendations for tackling the poverty–growth–inequality inter-relationship.

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