

# The Turning Period of China's Income Distribution

An Impact Assessment on Income  
Distribution-related Policies in China

## Executive Summary



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## Acknowledgement

China Development Research Foundation (CDRF) is dedicated to promoting equitable and inclusive development in China. In 2004~2005, commissioned by UNDP China Country Office, CDRF organized the preparation of 'China Human Development Report 2005: Development with Equity', through its expert network. This report was launched in 2005 and won UNDP's 2007 Human Development Award for Excellence in Policy Analysis and Influence. In 2011, CDRF launched the research project '*An Impact Assessment on Income-related Policies in China*'. The Foundation organized a research team constituted by outstanding scholars in related areas, and entrusted 12 commissioned reports. The research report volume has been published in August 2012. UNDP has provided financial support and substantive inputs to the research report. Ms. Renata Lok-Dessallien, UN Resident Coordinator in China has given a foreword to the publication of the research report. Mr. Christophe Bahuet, Country Director of UNDP China, and other staff, have supported the development of this project. Experts from UNICEF also provided constructive comments to the research. As research team leader, I would like to take this opportunity to thank all research team members, advisors, organizations and individuals who provided support to this project.



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China has seen remarkable progress in its economic growth since reform and opening up began. Still, as impressive as this transformation has been, growth has come at a considerable cost to income distribution between the rich and poor. Increasingly, China's gini-coefficient has highlighted alarming disparities in income gaps that have grown from less than 0.3 in 1978, to 0.4 in 1993 and 0.48 in 2007. The resulting excessive saving and insufficient consumption among Chinese residents have further hindered the government's ability to restructure the economy and transform growth patterns. In turn this has had a serious knock-on effect on social justice, social cohesion and the formation of a new consciousness on reform and development. As a result income distribution has remained at the centre of public policy research.

Since the end of the 1990s and after 2003 in particular, the Chinese government had implemented a series of policies aiming to promote a more balanced, coordinated, inclusive and sustainable economic brand of development. To some extent policies like the Balancing Regional Development Strategies, Construction of a New Socialist Countryside, Rural Poverty Reduction Strategy, Equalisation-Oriented Public Service Provision, Re-establishment of Social Welfare System, Proactive Labour Market Policies, Reforms of the Hukou System, Education Reforms, Reforms of Taxation and Fiscal Transfers, have each alleviated pressures caused by inequality.

However, with efforts to improve income distribution unable to fully keep pace with progress in rapid economic development, the China Development Research Foundation (CDRF), with the support of UNDP, launched a research project entitled '*An Impact Assessment on Income Distribution-Related Policies in China*'. Based on available data, this project has investigated trends in China's income distribution and seeks to examine the impacts that changes in income distribution have had on related policies over the last decade. It is intended for use in informing income distribution reforms.

## I. Income Distribution Trends in China and the Effects of Related Policies

### 1. Income inequality has been increasing, but has slowed in recent years

- a) Urban-rural income disparity. The urban-rural income ratio rocketed from 2.78 in 2000 to 3.23 in 2003, but increased at a relatively slow pace to 3.32 by

2007. Similarly steady increases were also recorded in the following two years. Furthermore, based on the Theil index, research shows that China's urban-rural income disparity contributed about half of the country's aggregate income inequality in 2007. The urban-rural income ratio then dropped consistently from 2010, and in 2011 decreased to 3.13. This represents a return to figures in 2002 and has increased hopes of narrowing China's income gap.

b) Regional income disparity. The provincial gini-coefficient for per capita GDP, without being weighted by population share, increased from 0.347 to 0.357, and then gradually declined to 0.264 in 2010. This is lower than figures taken from the mid-1990s and provincial per capita gini-coefficient for both GDP (constant prices at 1978) and consumption (current prices) also returned to level from the early 2000s.

c) Rural income inequality. The rural gini-coefficient for household income increased from 0.35 in 2000 to 0.39 in 2009. At the same time, in the future the income inequality among rural households is expected to be narrowed, owing to the faster income growth of low income groups in the period between 2010 and 2011.

d) Urban income inequality. Urban gini coefficient for household income rose from 0.32 in 2000 to 0.36 in 2005, remaining constant from 2005 to 2009. This result has since been questioned on account of systematic underestimation and subsequent revisions have shown that the urban gini-coefficient surpassed 0.4 in 2007. This widening in income inequality occurred at time when house prices soared and income gaps emerged between monopolistic and competitive industries – two of the main factors that contributed to pushing up urban income inequality.

e) Aggregate income inequality. China's national income gini-coefficient has been increasing since 2001 and rose from about 0.45 to 0.48 by 2007. Although no nationwide representative income survey data exists for monitoring income inequality trends after 2007, the research team has estimated that aggregate income inequality has increased only slightly over the past three or four years, maintaining a relatively steady status. In doing so it was acknowledged that hidden or 'grey' income and dramatic increases in 'black' income coming from informal economic activities and corruption may exacerbate income inequality and make it difficult to assess trends.



## 2. Institutional and policy limitations have contributed to income inequalities

Urban-rural income and regional income inequalities are two of the main contributors to aggregate income inequality figures. While dual urban-rural systems adopted in China's pre-reform period have contributed to urban-rural disparities, regional income indices are more closely related to imbalanced regional development strategies undertaken during the 1980s and 1990s. In addition, lags in reforming factor markets and monopolies caused by unequalizing institutions have also played a pivotal role in widening income gaps among different social groups. For example, once the impacts of human capital and other factors are controlled for, studies have shown that about two thirds of the wage differences between monopoly industries and competitive manufacturing industries that are examined can be attributed to the market structure of monopoly itself. Moreover, segmented social welfare systems have also enlarged income gaps between different social groups. In particular, gaps in pension coverage and rates available for public servants, urban employees and rural populations has increased rapidly in the recent years, meaning that the welfare system itself contributed to producing inequalities.

## 3. As China moves into the middle phase of urbanization and reached the Lewis Turning Point, its income distribution has entered a turning period

During the process of economic development, the forces '*pulling down*' income inequality always coexist with those '*pushing up*' income inequality. Recent changes in income distribution trends shows that China's pull factors are growing and are gradually closing on its push forces. Among various factors driving down income inequality in China are some temporary factors, like the increase of agricultural prices, employment growth caused by economic stimulus, and others to have emerged from economic growth. Some long-term factors can also be attributed to this change, like the shortage of labour, mass population migration, and urbanisation. This has provided opportunities for improving income distribution, yet the term '*turning period*' used here does not mean reductions in China's income inequality will be automatic after reaching a peak as it is described by the theory of '*Kuznets Curve*'. Instead, it is expected that in the near future income inequality will only increase at a much slower pace, with infrequent periods of decline. Thus income inequality is expected to remain a substantial development challenge during the period immediately

before the pull forces overwhelm those pushing inequality. What is known, however, is that the duration of this period will largely depend on whether or not, and to what extent China is able to reform unequalizing institutions and policies, and how much emphasis the Chinese government will attach to prioritising these efforts.

#### 4. Regional development strategies have mitigated inter-provincial inequalities period

Balancing regional development strategies implemented in the 1990s, including the '*Western Development Strategy*', '*Strategy on Reviving China's Old North-Eastern Industrial Base*', and '*Strategy on Central China Emergency*', have significantly reduced inter-provincial inequalities. Fixed asset investment, infrastructure construction, industrialisation and opening-up in Central, Western and North-Eastern China have accelerated, and has led to rapid GDP growth in these regions, especially after 2005. Between 2006 and 2010, the average annual GDP growth rates of Central, Western, and North-Eastern China reached 13.2%, 13.9% and 13.6% respectively – higher than Eastern China (12.3%) in the same period. Narrowing regional development gap in this way has since led to a decline in inter-provincial income and consumption inequalities.

#### 5. Rural poverty reduction has cut economic development gaps between villages over the past decade

During 2002-2009, the ratio of average incomes between poor villages and national rural figures increased by 5 percentage points, and the same ratio between poor counties and the national rural levels also increased by 3 percentage points. More importantly, China's poverty alleviation policies significantly improved production capacities and access to new markets among the poor, while they have also been attributed to decreasing their vulnerability to poverty. In poor rural areas, households who participated in poverty reduction projects had better economic performance than those who did not. While not necessarily surprising, it is worth noting that, although low income groups in poor rural areas benefited from infrastructural investments in their community, higher income groups usually benefited more from these investments; hence the ratio between income groups in the top and bottom 20 percent of the country increased from 4.6 in 2002 to 5.5 in 2009.

## 6. Gradual Hukou relaxation and proactive labour policies have improved the mobility of labor market and promoted wage convergence between migrant and urban workers, reducing wage inequality in urban labor market

In the last decade, the average income ratio between the top and bottom 10 percent of migrant workers declined from 5.9 in 2001 to 3.8 in 2010, down 35.9 percent. The gini-coefficient for migrant workers' wages has also declined 20 percent. After considering the impacts of demographic factors and working experience, it is found that 11 percent of wage difference between migrant workers and workers with a local hukou in 2001 could be attributed to the migrant worker status alone. This figure decreased to 5 percent in 2010. However, since most current household income surveys don't cover representative samples of migrant workers, income inequality between migrant and urban workers may be overestimated.

## 7. Deregulation of agricultural price controls increases rural income and narrows the income gap between rural and urban residents

Based on provincial panel data between 2003 and 2009, a one percentage point increase in the agricultural production price index would increase agricultural income and rural per capita net income by 0.63 percent and 0.27 percent respectively, and would reduce urban-rural income gap by 0.37 percent. The producer price index of crop products had a similar effect on rural income, as well as a significant impact on urban-rural income gaps. On average, every 1 percent increase in the producer price index of crop products leads to a 0.6 percent reduction of urban-rural income ratio. This analysis also indicates that during 2000-2009, if farmers' agriculture-related income did in fact increase by 1 percent throughout the country, the gini-coefficient for net rural income between provinces would be pulled down by 0.55-0.65 percent. It therefore appears obvious that combined increases in the agricultural production price index and the producer price index of crop products are highly conducive to narrowing down both rural and urban-rural disparities. However, on the other hand, since increases in the food retail price index had only a marginal impact on rural household income and urban-rural income gaps on account of the index being more affected by circulation costs, growth in this index is more likely to affect price levels than rural incomes.

#### 8. Increasing circulation of arable land is conducive to reducing urban-rural income gap, while possibly enlarging income inequality within rural areas

Econometric analysis has shown that China's approach to distributing land equally has equalised income distribution in rural areas. The launch of the '*Law on Land Contract in Rural Areas*' was responsible for encouraging the circulation of rural land, which in turn has had significant impacts on income distribution within rural areas and between urban and rural areas. It has been observed that a unit increase of arable land circulation enhances per capita agricultural income and non-agricultural income by 5 percent and 22 percent respectively. This is conducive with narrowing urban-rural income gaps but, since non-agricultural income has been a major source of rural income inequality, increased land circulation may widen rural income gaps.

#### 9. Free compulsory education policy mitigates income inequality by reducing education expenses for the poor and promoting human capital accumulation of poor children

Econometric analysis has also revealed that the implementation of free compulsory education has significantly reduced urban-rural income gaps in Western China. Although the expansion of tertiary education in the last decade has created more opportunities for poor rural students to enter colleges and universities, some case studies have shown that students from families with a perceived low social status had fewer opportunities to study in prestigious universities. Considering the large gap in education returns between prestigious universities and ordinary ones, tertiary education reform may have exacerbated income distribution in urban labour markets. It is also noted that, though education achievements at the national level has been improved significantly, China's share of labour income in terms of GDP has continued to decline over the last decade. This is contrary to prediction made using the classical human capital theories. The temporary over-supply of well-educated labour, poor protection of labour rights, and division of labour markets are thought to have caused this contradiction between theoretical predictions and the Chinese reality.



## 10. The Central transfers to the local governments has enhanced equalization of provincial fiscal capacities and public services provision

The equalising nature of inter-governmental transfer does not show any signs of having a direct impact on household income, but has indirect implications for narrowing regional income gaps by bridging voids in public services among different provinces. Analysis shows that tax rebates from the Central government to the local government have had little effect in this regards. Nevertheless, since the taxation reform launched in the mid-1990s, the share of tax rebates from the Central government to provincial governments decreased from 72.9 percent in 1996 to 15.5 percent in 2010. It can be said that both general-purpose and earmarked intergovernmental transfers have had a significant and comparable effect in equalising provincial fiscal capacities. In 2009, a one percentage point increase in general-purpose and earmarked transfers have reduced the per capita gini-coefficient for fiscal revenue by 0.17 percentage point and 0.14 percentage point respectively.

## 11. Tax reforms prove positive in increasing disposable income of lower income groups

The exemption of agricultural taxes has reduced the tax burden for poor communities (especially pastoral farmers) by 130 billion yuan since 2005 – equivalent to US\$21 billion. In other words, the net income of rural households increases by 140 yuan thanks to the policy, which accounts for about 5 percent of their total income. In 2011, the income tax threshold was raised from 2,000 to 3,500 yuan per month. Owing to this adjustment, the amount of people paying income tax decreased from 84 million to 24 million. In addition, China also stopped collecting interest tax, even though such termination is more beneficial for the rich. The role of property tax in income redistribution is still limited, but is expected to play an important role in the future.

## 12. Recent Latin American experiences show that decreasing wage inequality and equalizing public service provision could play an important role in mitigating income inequality

Most major economies have been experiencing widening income inequalities in the last two decades, with the exception of many Latin American countries.

Among 17 countries with comparable data in Latin America, 13 have witnessed a decline in income disparity, with their average income gini-coefficient down by 1 percent annually. Like China, these countries when taken as a whole experienced very similar historical challenges as China when it comes to income distribution and therefore, lessons can be drawn from their experiences in redistributing income more equally. Case studies from Argentina, Brazil, Mexico, and Peru show that the decline of inequality in these four countries is strongly associated with decreasing differences in hourly wages and increases in access to education for the poor. In addition, the integration of labour markets also promoted a decline of wage inequality, while it was found that governmental transfers, in particular conditional cash transfers to vulnerable groups, played an important role in further reducing income inequality.

## II. Recommendations for Further Reforms on Income Distribution System

Based on the impact assessment of domestic policies and international experiences, the CDRF research team has made the following policy recommendations for further reforms on income distribution:

### 1. Give priority to improving primary and redistribution policies

For most households the share of income from primary distribution in total income is much higher than that from governmental transfers, meaning that equalising primary distribution is likely to have a more significant impact on narrowing income disparity. In short, what this means is that the government should move to break down institutional obstacles that may be hampering effective market operations, promote market integration, and reduce market failures, rather than intervening in the normal operation of markets. Policies should vary for different income groups: for low income groups, government transfer schemes could play a more important role; for middle income group, labour market policies are of more significance; and for high income group, redistributing incomes through taxation reform should be considered.

### 2. Deepen reforms on state-owned and monopoly sectors

Access restrictions should be further removed for the private sector to enter banking and finance, railway, electricity, and energy markets so as to promote

healthy competition in these sectors. State-owned enterprises should also reposition themselves to pay more dividends to the government so as to support a universal social welfare system, and consider securing investment in other public services.

### 3. Accelerate the Hukou reforms to promote urbanization and integration of the labor market

The threshold for obtaining hukou status in metropolitans and large cities should be lowered substantially. Hukou system reforms should however, be taken step by step in order to maintain stability in demographics and labour markets. Those who have steady jobs and have contributed to social insurance schemes for three years or more should be eligible for hukou status in metropolitans and large cities. In addition, it will be important to enhance access to basic public services, like housing, pension, education, and medical security schemes for migrant workers and urban residents.

### 4. Deepen rural land reform and undertake a more equitable compensation system

Compared with land circulation policies, increasing the compensation offered during the land expropriation process will have a direct and more significant effect in narrowing urban-rural income gaps on account of the fact that rural families will not have their most important asset taken from them with low compensation in return. Such mechanisms would need to vary in line with the specific contexts of different regions.

### 5. Promote reforms on the commodity circulation system

Government taxes and fees related to commodity circulation, including logistics industries should be lowered substantially, so as to leave space for the growth of agricultural income without substantially increasing agricultural prices.

### 6. Establish and implement a national human capital development strategy

The Central government should formulate and launch a comprehensive ‘*Early Child Development Strategy*’ with goals for 2020. Such a strategy would help to

promote the nutritional status of children under 6 and provide universal access to pre-school education. In addition, subsidies for compulsory education should be increased to ensure access to quality schooling, while investments should be made in vocational education and training to promote reforms in tertiary education systems, so as to lay a solid foundation for upgrading much-needed national industrial capacities.

## 7. Optimize the inter-governmental fiscal transfer system

General-purpose and earmarked transfers should be reclassified according to the functions of specific transfer schemes, so as to promote local governments' capacity to use funds to provide more encompassing public services. In doing so, it will be necessary to intensify transfers that focus on socially vulnerable and poor regions.

## 8. Further strengthen the reforms on structural taxation reduction

The government should take further steps to cut taxes and fees collected from Small and Medium Enterprises and wage earners. In addition, with the precondition that the overall tax burden would decrease modestly, it is necessary to expand property tax pilots and to collect taxes related to resource use on the premise.

## 9. Accelerate budget system reforms

Budget disclosure systems for governments at the Central and local levels should be established and where already in operation, deepened. This can be achieved by enlarging the scope of information disclosure and detailing the contents of budgets, so as to further improve budget transparency. Pilots on participatory budgets should be expanded to improve the participation of social vulnerable groups in the decision-making process. Steps to strengthening expenditure tracking and budget performance assessments should also be taken to promote accountability.

## 10. Strengthen the anti-corruption framework

It is necessary to establish effective and comprehensive asset disclosure systems for public officials, to restrict and eliminate corruption-related income.

Reducing administrative approval items will be crucial to controlling rent-seeking practices. The government should also look to strengthen the illegalities surrounding anti-corruption and increase punishments for such behaviour.





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