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Foreword

Lin Yifu

The following is an edited translation of the foreword, written by Prof. Lin Yifu of China's Economic Research Centre, Peking University, and also Honorary Researcher of Unirule Institute of Economics.

Economics in China—1999 is the latest volume in the series of “*Economics in China*” conducted by Unirule Institute of Economics. The compiling process this time is not much different from that for previous volumes. It goes first through the stage of recommendation from those editorial departments of various academic journals, then the preliminary selection by Executive Editor-in-Chief of the Compiling Committee, and at last the final version of the book via the process of voting by all members of the Committee. The theses selected in the volume are widely regarded as representing the best of the economic research papers published domestically in the year of 1999.

Altogether, there are three papers selected in the volume in the year, concerning the theme of income distribution and income inequality amongst domestic regions. “Research Anew on Distribution of Individual Income in China”, put forth by Li Shi and Zhao Renwei, is ba-

sically an abstracted report of the research project of the same theme done in 1999, after their successful completion of the authoritative paper entitled "Research on Individual Income Distribution in China" in 1994. There is little doubt that it is yet another authoritative paper done by them and will once again contribute greatly to their research field as it provides a huge amount of valuable information in that area.

The report, following the brief introduction of the framework under which the research was conducted and the methodology used, puts forward the research findings on the current status of income distribution in China, the factors at play, and the trend of change in the inequality of income distribution. Based on these findings, it also offers the likely policy advice. The report, in particular, concludes that the level of such inequality had by and large climbed to that above the medium in the world by the time of the mid 1990s. As well, it sets forth the research methods whereby the researchers, with various quantitative tools, undertook a structural analysis on the causation of increasing spread in the inequality of income distribution in China, which is indeed one of the contributions of the research.

Specifically, the report demonstrates that in terms of the level of income inequality between urban and rural area per se, China has at length joined the world's highest group. Over the period of 1988 - 1995, for example, the increment of the gap between urban and rural area accounted for 16.5% of the total at the overall level. Within each area, moreover, the inequality also shows upward trend. One intriguing difference here is that the gap within rural area is widening smoothly, whereas within urban area, it is jumping ahead.

It is important to note, in addition, that the increment of gap in

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the inequality amongst three regions of the east, the central, and the west over the period of 1988 – 1995 accounted for 13.5% of the total. One of the direct consequences of the widening of the gap is that it will greatly impact upon the distribution of poverty amongst the regions. According to the author, “the state of poverty in 1995 was far beyond what we could possibly imagine”. Since then, however, both the central and regional governments have enhanced their policy support programmes aiming at the poverty relief in those poorest regions as much that the situation should be more or less improved, especially for those far below the poverty line.

As regards the causation of the increase in income gap, the researchers offer their explanations from the following three aspects, economic development and growth, economic reform, and government policies. With respect to the development and growth, a rapid expansion of the efficiency-driven non-state-owned sector has been the main factor in enlarging the gap in income distribution. The unequal distribution of the non-agricultural income amongst rural households has been another factor within rural area. The difference in the stock of wealth resulted from the difference in the flow of income, in addition, can hardly be ignored as a cause of widening the gap through interest income earned.

On economic reform, the implementation of various kinds of reform measures aiming at improving the efficiency of the economy can be one of the main factors accountable for the gap widening. Concerning government policies, however, there are two points raised in the report that draw attention. One is that the increase in the prices of agricultural produces can reduce the gap not only between urban and rural area,

but also within the rural community itself. The other is that the regressiveness has been persistent in the income tax regime in China. According to the author, the system of redistribution via personal income taxation is not only too weak, but also somehow reinforcing the state of income inequality.

The statistics from the survey in 1995 shows, for example, that the average income received by the residents in rural area is only 40% of that in urban area. However, they have to shoulder the burden of tax levy alone 9 times as large as those living in urban area. If taking into consideration the various kinds of surcharges carried by rural residents, the burden will be 30 times as large. In addition to that, the lump-sum tax (i.e. a head tax on each individual) is applied within rural area. That has reinforced the regressive nature of the rural taxation, and thus further widens the gap of income inequality within.

Another paper concerning the theme of income distribution is on "Rural Labour Flow in China and Income Growth and Distribution", written by Li Shi. As the topic says, the focus of the paper is about the impact of the flow of rural labour since the economic reform on rural households in terms of income growth and distribution. With 1% of the random sample from the 1995 census, Li starts with his estimation of the widely believed scale of rural labour outflow within the country as well as individual provinces. He also attests the hypothesis on the structure of labour flow, that is, the proportion of the migrants into a region has much to do with the degree to which the labour market in that region develops. Based on these findings, more ink is poured upon the impact of the labour outflow on the income growth and distribution within rural area.

Li, in his analyses of the average income level between the rural households that have family members working outside the region and have not, discovers some interesting phenomena. At the aggregate or country level, the average income level of the former is slightly lower than that of the latter. In those more developed provinces, moreover, the same is also true. To this second point, however, it is not hard to understand as the wages of the rural labour in more developed provinces are relatively higher than in other provinces. As for those of less developed provinces, the reverse is true.

Because of the fact that at the aggregate level, the average income of the rural households that have someone working outside the region is 1.5% lower than the households that have not, and also 16% lower in terms of the average income of working members of the households, it is easy for one to conclude that the outflow of rural labour is not beneficial to the increase in rural household income. To this point, Li carries out his econometric analysis that says, under the restricted condition of controlled factors as land, productive capital and location (i.e. different provinces), the marginal contribution to the rural households of the former is 9.4% as large as the latter.

Another hypothesis relevant is that the resources left in a rural household after some family members working out would be reallocated so that the outflow would increase the marginal productivity of those remained behind, provided there is the existence of spare capacity in this kind of rural households. The econometric analysis of 9 provinces as well as the country average strongly supports such a hypothesis, and thus it can be said in accordance with the analyses above that the outflow of rural labour is very much conducive to the improvement of

income in rural households.

In respect of the impact of labour outflow on income distribution within rural area, Li carries out his analyses in two ways. One is from the aspect of net incomes sent or brought home by those working outside. The result is consistent with what is widely expected that the incomes brought home have a positive effect on reducing the inequality of income distribution in rural area. The other way is to take the marginal contributions of those working at home as the opportunity costs of those outside, which are subsequently compared with the actual incomes earned by those working outside to see the effect on the distribution. The result shows that at the aggregate level, the gap of inequality in income distribution within rural area would only be increased if those working outside remained at home. Nonetheless, it is unclear that the result still holds at the level of different provinces.

On policy advice, the fifth and the sixth point raised in the paper deserve much of attention. In the fifth point, Li points out that it is rather the choice of peasants themselves than the planners' intention as whether to move to the large or the small & medium-sized cities. The sixth point suggests that it is possible to stop influx of rural migrants by increasing the cost of living in cities, and in the same mode to induce some of the population in the large cities moving to the small & medium-sized cities. What Li wants to say here is that if the advice is feasible, then the governments can possibly create the small & medium-sized cities likewise. Hence, it is the planning methods adopted by the governments rather than establishing those cities themselves that deserve naysay.

Yue Ximing's paper on "Income Transfer and Income Inequality

amongst Regions—Japan's Experience" is the third in the volume with relation to the theme of income distribution. The main focus is on income differences amongst regions. Specifically, Yue making use of the historical GDP data on individual provinces released of late by State Statistic Bureau, probes into the unequal state of production and consumption amongst regions over the period of 1952 – 1995 and the trend of change.

In his paper, Yue argues that the productive differences amongst the regions, measured by what he calls "altering coefficient" of GDP per capita, had been growing until 1978 (excluding the period of "Great Leap Forward") when the reform was initiated. Since then until around 1990, the differences tended to narrow down. Thereafter, however, it went upward once again. The consumption differences, on the other hand, when measured by the "altering coefficient" of average consumption, had moved up and down throughout without clear signs of spreading off until 1982, then went up during the period of 1983 – 1990 and stayed there with some fluctuations since.

Subsequently, Yue, with the ratio of the "altering coefficient" of GDP per capita to that of average consumption, analyzes the correlation between the differences in production and consumption amongst the regions. The result shows that the ratios amongst sample regions are all bigger than one, indicating that the differences in production are larger than in consumption amongst these regions. The only variation shown in the result is that the ratios had been increasing before 1978 and gradually narrowing down thereafter.

Clearly, Yue's findings over the period of 1952 – 1995 runs against the common sense of that high consumption is usually staying

with high production so that the differences between production and consumption amongst the regions should exhibit a positive relationship. Nonetheless, the author does provide his own explanations.

From the production point of view, the output (GDP) of a region goes to three kinds of uses, consumption within the region, investment within, and net export. For a given GDP, they move up and down on a zero-sum line at the GDP level. And thus, the average consumption in a region is endogenously related to its investment and net export. Prior to 1978, Yue argues, the transfer payment policy adopted then by the central government had by and large ironed out much of the differences in consumption amongst the regions while the gap in production kept expanding. After 1978, however, the production and the consumption of the regions started to become synchronized due primarily to weakening capacity of the central government in the policy of transfer payment amongst domestic regions.

Li's explanation suggests that the disparity in production amongst the regions have grown in recent years due to the increase in the long-term productive capacity in the more developed regions, as more output in these regions can be used for investment within. If there were no transfer payment amongst the regions by the government, then the consumption in the more developed regions would go up further along with their production. The result would be a comprehensively widening of the gap in both production and consumption between the more developed and the less developed regions.

In so far as the analysis of the empirical evidence is concerned, Yue has got into the root of the problem when he provides his explanation on the differences in both production and consumption of the re-

gions prior to the reform. Nonetheless, his explanation of the phenomenon after the reform falls short of being satisfactory. If the main cause of the leveling off in consumption is because of the reallocation of the resources amongst different regions by the central government under the command regime, then widening the gap in consumption amongst the regions after the reform cannot be attributed to the weakening of the capacity in payment transfer by the central government. It is more of the case of making use of regional comparative advantage that might well be the main factor to look into.

That is to say, at the time of the reform, different regions were on different levels of development, and thus had different comparative advantages. Relatively speaking, since the reform, the eastern regions have made more successful use of their comparative advantages that has seen a rapid expansion of many non-state-owned labour intensive enterprises. As a result, these regions have not only achieved faster growth in production, but also in workers' incomes. True, the transfer payment policy does impact upon the regional differences in both production and consumption, but it is hardly a critical factor at play. Only by recognizing this point, the likely mistake in the policy making process of over-relying on the transfer payment to solve the problem can be avoided.

The volume this year also includes two papers that centred on the theme of industrial organization. One is on "The Foundation of Property Rights on Which Perverse Competition Is Based", done by Zhang Weiying and Ma Jie. The other is Jiang Xiaojuan's paper on "Institutional Transition and Industrial Development: a Research in a Number of Industries". The former is rather theoretical and the latter more on

empirical research.

Over the period of transition in domestic economy, one of the prevailing phenomena has been as sort of excessive competition amongst domestic SOEs, which ultimately results in the market prices for some products below their marginal costs of production—perverse competition. The paper, put forward by Zhang and Ma, is about their research that delves into this problem from the angle of property rights, in that they first set up the objective function of the managers in the SOEs that have obtained the status of separated right from the central government in their daily operations. The function goes:

$$g^i = \beta_i P(Q) q_i - \alpha_i C_i(q_i)$$

Where:

$P(Q) q_i$: the revenue of the firm “ i ”;

$C_i(q_i)$: the gross cost of the firm “ i ”;

β_i & α_i : the share of a manager's responsibility in the revenue and the gross cost of the firm “ i ”, respectively.

The maximization of the managerial objective is deduced as the following:

$$\frac{\beta_i}{\alpha_i} P(Q) q_i - C_i(q_i)$$

Where:

$\frac{\beta_i}{\alpha_i}$: the structure of the property rights of the firm “ i ”.

When:

$\frac{\beta_i}{\alpha_i} = 1$: a private firm in which the maximisation behaviour of the manager is the same as the one in neo-classical theory;

$\frac{\beta_i}{\alpha_i} \neq 1$: a state-owned enterprise;

$\frac{\beta_i}{\alpha_i} \geq 1$ (or $\beta_i \geq \alpha_i$): benefits accrued to the rights are more than the costs of the responsibility.

When this last inequality holds, the property rights will be distorted, which is one of the necessary conditions for the occurrence of the situation where the prices are below the marginal costs of production.

Zhang and Ma, by using a standard non-cooperative play-out in the game theory and a standard microeconomic analysis, arrive at the possibility of perverse competition in the SOEs and the detailed conditions under which perverse competition takes place (i.e. the degree to which property rights are distorted and the level of the technical advance). Finally, the welfare effect of perverse competition is systematically measured.

With the assumptions given, the entire paper exhibits inherently logical consistency. Nonetheless, the validity of the model is yet at large as it falls well short of empirical testing necessary. On the principal conclusion, moreover, the paper argues that, if the degree to which the property rights are distorted is high enough, plus the backwardness of the technology used, then it will induce perverse competition. However, the notion of such a kind of competition is defined right at the outset of the paper as a kind of price-setting behaviour (i.e. actively responsive to market conditions rather than passively reactive to property rights) that produces the price below the marginal cost. What's more, the model has already assumed that all firms are employing the technology with its marginal cost as a constant.

If the price war taken place a few years ago in domestic TV industry can be regarded as fit for the notion of perverse competition given in the paper, there will be at least one rough way to see the missing validity of the model, though far from being thorough due to the size of the sample taken. Nonetheless, the empirical evidence we have here does not lend itself to supporting the main findings of the paper.

As for the robustness of the model, the paper in its definition of the private enterprises (i. e. $\beta_i/\alpha_i = 1$) implicitly postulates that the perverse competition will not occur to the private sector. The empirical evidence in China as well as overseas, however, says otherwise. One of the earliest perverse competitions (whose nature fits into the definition of the notion in the paper) in China, for example, took place in domestic VCD industry that consists mainly of private firms. In so far as the equation of $\beta_i/\alpha_i = 1$ is concerned, furthermore, it can be written as $\beta_i/\alpha_i = 1/1 = 1$, but also can be rewritten as $\beta_i/\alpha_i = 0.0001/0.0001 = 1$. Under the framework of the model, there will be no perverse competition in both situations. Such a conclusion would be a bit far-fetched and thus less convincing.

Given the fact that the economy since the early 1990s has exhibited an excessive capacity, wouldn't it be better and much easier simply to apply the framework of supply-demand to the explanation of the phenomenon? Is that possible, too, that the "perverse competition" prevailing in the economy is actually the fallout of on-going disinflationary trend in recent years? That aside, nevertheless, the paper has still been selected, as it not only displays the logical consistency as mentioned above, but also demonstrates the concise and well-trained quantitative skills in their modeling, which is no doubt one of the crucial

steps that the economists in China have to get over.

The other paper collected on the theme is Jiang Xiaojuan's on "Institutional Transition and Industrial Development: a Research in a Number of Industries". Ever since the reform was initiated some twenty years ago, there have been many valuable ideas and thoughts generated along the way with regard to the so-called "gradual approach" mode of the reform. Some, to name but a few, argue about the robustness of the approach; others on the necessary condition of a successful reform, questioning the radical privatisation movement. But as Jiang stated in the paper, "these discussions, on the whole, either belong to the category of economic hypotheses, or 'take a short-cut' by making use of those aggregate data, instead, although they do provide some insights, enlightening ideas and probably a brand new theoretical perspective".

As Jiang says, the effort is exerted in the rather detailed research that delves into the actual process of the transition, achievements attained and the differences amongst industries. The result shows that at the industrial level, there is no clear sign of correlation between the proportion of non-state-owned firms and own industrial growth. Thus, the paper concludes that non-state-owned firms' contribution to the growth of own industry is not significant, even though it is a quite significant factor in explaining the growth at the sectorial level.

Also, the research, in response to the widespread belief that there is the existence of duplicative production and the failure to obtain economies of scale in domestic manufactory sector, probes into 5 such industries as refrigerator, washing machine, TV, light vehicle, and textile. Jiang, with these 5 industries' data in 4 years, that is, 1980, 1985, 1990, and 1995, analyses the change in each industrial struc-

ture during the period of the transition. Classified by the scale of manufacturers, the research does not find any clear evidence that supports such a belief, and thus concludes that over the past 20 years, there have not been clear signs of reduced scale, deterioration of industrial structure, and worsening in achieving scale economies in the manufacturing sector in China.

There are two things in the paper that deserve attention. One is about the criteria raised in the paper that measure the degree of the transition—rules, behaviour, and achievements. By specifying these criteria, Jiang shows her deep understanding of the current transition in China, which is in stark contrast with those who actually believe in the reform with one strike via privatization. Here, it is important to note that we are living in the stochastic rather than the deterministic world, in which the changes in individuals' behaviour not only are unpredictable, but also will take a gradual rout, even if other criteria, such as rules of law, could be changed relatively quicker.

The other is about the implication at some point of the paper, if not mistaken, that the scale of economies is always positively related to the size of a firm. If it is applied to the capital-intensive technology, no eyebrows raised. As for the labour intensive technology, however, the otherwise will occur from time to time. To this end, Jiang in her effort to measure the scale of economies should not have taken the textile industry on board in the first place.

On macro-economy, there are six papers included. The first is Zhang Fan's paper on "Behaviour of the Government, Effect of Interest Rate, and *IS-LM* Model in China". Besides offering its direct conclusions, most importantly, the paper sets forth a dire warning for both