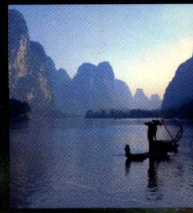


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China's GDP per capita has grown at a remarkable 8.2 percent a year since economic reforms started in 1978. Market incentives have diversified employment, increased factor mobility, and boosted returns to land and human capital. Overall, a staggering 200 million people have been lifted out of poverty.

But the benefits of growth are unevenly distributed. People with schooling, mobility, and good land have been able to take advantage of the new market opportunities, helping to spur growth. But government policies, or their absence, are heightening inequalities. Social policies favor urban areas. Economic policies favor the coast. Access to education, health care, and employment opportunities remains

unequal or has become more so. And gender disparities in the marketplace may be more pronounced.

Elsewhere, high inequality has depressed growth, undermined poverty alleviation, and contributed to social tension. China's income inequality, similar to that in the United States, remains moderate by international standards. But even though it may continue to rise as the country's transition unfolds, increased inequality need not undermine growth or social harmony—provided it is accompanied by broadly based growth, equal access to opportunities, and protection for the poor and vulnerable. The challenge for the Chinese government is to extend the benefits of growth to all members of society.



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Special Administrative Region, People's Republic of China.



Overview

 hina's income distribution has become increasingly unequal since reforms started in 1978. The Gini coefficient (a common measure of income inequality), a low 28.8 in 1981, reached 38.8 in 1995. A change of this magnitude is highly unusual and signals deep structural transformation in the distribution of assets and their returns.

Inequality has risen in large part because China has begun to harness the enormous potential of its people, suppressed during the first three decades of Communist rule. At the height of egalitarianism individual remuneration barely reflected productivity. In 1978 the government introduced individual incentives and market forces that immediately began to increase returns to capital and land, diversify employment, and increase factor mobility. Not surprisingly, the benefits of growth were distributed unevenly, accruing to those most able to take advantage of rising opportunities—the educated and the enterprising,

the mobile, and those with high-quality land. To some degree inequality was necessary for the rapid growth that followed the adoption of reforms. But government policies, or their absence, are exacerbating inequalities. Social policies favor urban over rural areas, economic policies favor the coast over the interior, and access to education, health care, and labor mobility remains unequal or has become more so. And the price of admission to a more affluent society appears to be higher for women than for men.

Should China's policymakers be concerned about the increasing polarization of incomes? Elsewhere, high inequality has impeded growth, undermined poverty alleviation, and contributed to social tension. China's income inequality is still moderate. The benefits of growth have been unevenly distributed, but they have reached the poor. Moreover, much of the increase in inequality reflects a welcome adjustment to an incentive and remuneration structure more typical of market economies. But if not moderated, some aspects of China's inequality may imperil future growth and stability.

Social tension can result when the benefits of growth accrue unequally to easily identifiable groups—for example, geographic and urban-rural imbalances, inequalities between ethnic groups, and gender disparities—even if these are not major factors in explaining overall income inequality. If richer groups enjoy consistently higher growth, simmering social tensions can become politically destabilizing and ultimately derail growth and poverty reduction. Social and economic progress can also be damaged by rising inequalities in opportunities. Experience elsewhere suggests that inequalities in access to basic health and education typically accompany higher income inequality and can intensify its negative effects on society. Policymakers in China need to manage the widening gap between rural and urban areas, the growing disparities between the coast and the interior, and the increasing inequality across income groups in access to opportunities for self-improvement.

Progress and problems

Although China's income inequality has risen rapidly, it has not yet pushed the country into the ranks of the notoriously unequal. China's Gini coefficient is now

similar to that of the United States and close to the East Asian average—substantially higher than in Eastern Europe but much lower than in Sub-Saharan Africa and Latin America (table 1).

Moreover, China's spectacular growth has been accompanied by substantial gains in poverty reduction. Since the start of reforms in 1978, China has lifted some 200 million people out of absolute poverty. But progress has been uneven. Most of the poverty reduction occurred in the early part of reforms, when the household responsibility system was introduced in rural areas. But in the mid-1980s and early 1990s poverty levels stagnated despite steady gains in per capita GDP. Since 1992 renewed momentum has decreased the number of poor, and by the end of 1995 less than 6 percent of the population had incomes below the absolute poverty line.

Growth in rural incomes has transformed poverty statistics. Per capita GDP growth did not always increase personal incomes, but when it boosted rural incomes, poverty declined. Without rural income growth, the number of absolute poor in China would have increased by more than 100 million between 1981 and 1995 because of adverse distributional changes. Instead, the ranks of the poor fell by more than 150 million.

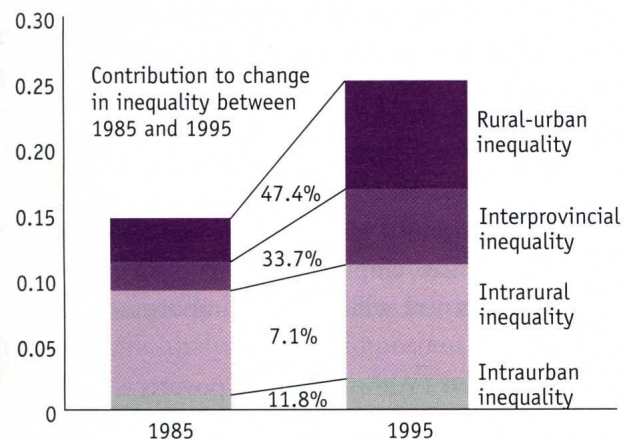
But there is no room for complacency. Reforms have not reduced the large welfare differences between rural and urban households; on the contrary, these have increased. Policies favoring the coast have reinforced the region's natural endowments, widening the gulf between coastal and interior provinces. Market forces have raised productivity, but labor markets remain segmented. And if the marketplace alone is left to dictate

TABLE 1
China's inequality puts it in the middle of the pack internationally
(Gini coefficient)

Region or country	1980s	1990s
Eastern Europe	25.0	28.9
China^a	28.8	38.8
High-income countries	33.2	33.8
South Asia	35.0	31.8
East Asia and the Pacific	38.7	38.1
Middle East and North Africa	40.5	38.0
Sub-Saharan Africa	43.5	47.0
Latin America and the Caribbean	49.8	49.3

a. Data are for 1981 and 1995.

Source: Deininger and Squire 1996; Ahuja and others 1997.

FIGURE 1**China's increasing inequality is driven by the rural-urban gap and provincial disparities***Theil index*

Note: Inequality (the Theil index or mean log deviation) is decomposed first into urban and rural and then into its regional components.

Source: World Bank staff estimates based on State Statistical Bureau data.

social conditions, the quality of China's human resources may become more and more uneven, creating and isolating winners and losers based on education, assets, and, increasingly, gender.

The rural-urban divide is increasing

China's urban dwellers enjoy a considerably higher standard of living than their rural counterparts. Rural incomes grew rapidly in the early period of reforms but in 1985 began to trail the increases in urban incomes, a trend reversed only in 1995. According to official data, the rural-urban income gap explained one-third of total inequality in 1995 and one-half of the increase in inequality since 1985 (figure 1). Internationally, the urban-rural income ratio rarely exceeds 2.0—as it does in China—and in most countries it is below 1.5. But even China's high ratio fails to capture the full extent of disparities in living standards between city dwellers and rural residents. An elaborate set of publicly provided services—housing, pensions, health, education, and other entitlements—augment urban incomes by an average of 80 percent. And when official data are adjusted, rural-urban disparities accounted for more than half of total inequality in 1995 and explain even more of the increase since 1985.

China's large rural-urban gap points to imperfect mobility in factor markets, especially for labor. Despite

increasing accommodation of the swelling demand for rural emigration, important impediments remain, reflecting the government's desire to control the pace of migration and to ensure grain self-sufficiency. The absence of a housing market and limited access to social services in urban areas pose additional constraints to labor mobility.

Regional disparities are widening

As China opened to the outside world, the coastal provinces were poised to seize opportunities presented by their proximity to world markets, access to better infrastructure, and educated labor force. But they were also helped by the central government's preferential policies, which stimulated foreign investment. As a result interprovincial inequality has risen. It accounted for almost a quarter of total inequality in 1995 and explained a third of the increase since 1985 (see figure 1). In 1985 residents of interior China earned 75 percent as much as their coastal counterparts; by 1995 this had dropped to 50 percent.

Access to opportunities is becoming less equal

People's different endowments suggest that inequality in outcomes is not only unavoidable but also that it can help nourish creativity and spur growth. As a result most societies tolerate some inequality in income. How much depends on the historical and cultural factors shaping each society's preferences. Much of the increase in China's income inequality needs to be evaluated in the context of the country's systemic transition. Transition has brought an adjustment in relative prices, revaluing endowments and characteristics that are conducive to productivity gains. Such adjustments are acceptable.

More insidious is inequality in access to opportunities to improve incomes and welfare, which also has been found to hamper growth prospects. China's highly egalitarian land distribution has helped protect the nutritional status of the poor. But educational attainment and access to health care are becoming less equal as market orientation encourages cost recovery in public institutions. There is also evidence that families invest less in girls' than boys' education and health. Coupled with rising discrimination against women in the labor market, this tendency threatens to erode

women's hard-earned gains, which have been a source of national pride. Finally, imperfect labor mobility creates unequal access to better-paying jobs. China's segmented labor markets are reflected in the near-absence of urban poverty, the relatively low level of urbanization, and the large rural-urban income gap.

Policies to grow with

Income inequality may well continue to rise as China's transition unfolds. But increasing inequality need not undermine growth or social harmony—so long as growth is broadly based, policy biases are eliminated, and the poor and vulnerable are protected.

Protecting the poor and the vulnerable

Investment in human capital is key to long-term improvements in welfare for all, but other policies can usefully differentiate treatment by segments of the population.

The absolute poor. In 1995 there were 70 million absolute poor in China. If current assistance programs were targeted more accurately, they would alleviate more poverty and cost less. In 1990 almost half of China's poor lived outside the counties designated for special assistance programs. These programs would be more effective if they were targeted at the level of townships, or perhaps even administrative villages

The government should also consider refocusing priorities in its poverty reduction strategy. A renewed emphasis on basic education and health services for the poor is essential, combined with assistance for finding employment in economically advanced areas. There is a need to ensure essential health services for the poor and to strengthen public health programs. Poor households must be compensated (through scholarships) for the costs of educating their children, and in this the government is aided by the demographic transition—the number of school-age children is declining. Government assistance to the poor in finding jobs outside their immediate home area should be expanded because remittances contribute significantly to reducing rural poverty.

The near poor. About 100 million additional people survive on less than \$1 of income a day (in 1985 purchasing power parity dollars) and derive almost half their

incomes from grain, a heavily regulated subsector. Reforms in grain policies are needed to improve this group's standard of living. Greater integration in labor markets and better-functioning credit markets would also help. The government's decision to align grain procurement prices to market prices is welcome. Better transport infrastructure and changes in the grain distribution system would help boost farmgate prices, and more spending on agricultural research and extension could increase yields. Above all, the near poor would benefit from shifting out of low-return grain production into higher-value crops or off-farm employment. But such shifts would require government willingness to import more food.

Urban poverty. Although urban poverty is negligible, it may become an increasing concern as enterprise reforms deepen and China continues to urbanize. Unemployment (including furloughs) in China's cities has already reached 8 percent of the labor force. The government needs better information about the urban poor to develop assistance programs for them. Establishing a meaningful urban poverty line would help, as would systematic monitoring of the unemployed. Now is also an opportune time for the government to examine its social protection system; substantial work has already gone into analyzing the pension and health care finance systems. Additional efforts should concentrate on other benefits such as unemployment compensation, disability, and labor training and retraining schemes. Finally, a better job information system would facilitate the redeployment of labor, while a systematic evaluation of urban job creation programs would help disseminate the lessons of their success or failure.

Eliminating policy biases and strengthening regulations

Public policies in China tend to exacerbate the gap between rich and poor. Policy changes in four areas would benefit welfare and income distribution.

Redressing the urban bias. Housing, food, migration, credit, state employment, and other policies provide de facto subsidies for urban residents. Some of these policies directly lower the welfare of rural residents. Others do so indirectly, by preempting public resources that could be targeted at more needy populations.

Removing the coastal bias in economic policies. The natural and human capital advantages of the coastal provinces are sufficient to attract foreign investment and need not be bolstered with preferential policies. In addition, a reformed intergovernmental transfer scheme would reduce disparities in public spending across provinces; the government should accelerate its design and implementation. Policies that favor the interior also may help address the widening gulf between China's interior and the coast, but additional research is needed on an appropriate package of regional growth policies. International experience with regional development efforts has generally been negative, but there has been little systematic analysis of this important issue.

Countering gender bias in household allocation decisions and in the marketplace. Education grants can provide incentives for families to educate girls. Government

can make the retirement age for men and women the same and avoid discrimination in benefits provision. Regulations and firm-level subsidies can spread the costs of child rearing, which usually are shouldered solely by women.

Dealing fairly with the rich. Some of China's newly rich have worked hard and taken calculated risks to benefit from new market opportunities. But others are taking advantage of China's incomplete transition to accumulate ill-begotten wealth. The government is right to focus on the second group. To combat corruption and to counter rent-seeking behavior, the government must enforce its regulations. Doing so will require reducing bureaucratic discretion, establishing clear and transparent rules for public decisionmaking (such as public procurement), and stamping out access to insider information in financial markets.

chapter one

Richer but Less Equal

s China's reforms have continued, its income distribution has become more unequal. In 1981 China was an egalitarian society, with an income distribution similar to that of Finland, the Netherlands, Poland, and Romania. But rapid economic growth has brought dramatic change, so that China's income inequality is now just about average by international standards (figure 1.1). In 1981 China's Gini coefficient (a measure of inequality of income distribution ranging from 0, absolute equality, to 100, absolute inequality) was 28.8. By 1995 it was 38.8—lower than in most Latin American, African, and East Asian countries and similar to that in the United States, but higher than in most transition economies in Eastern Europe and many high-income countries in Western Europe.

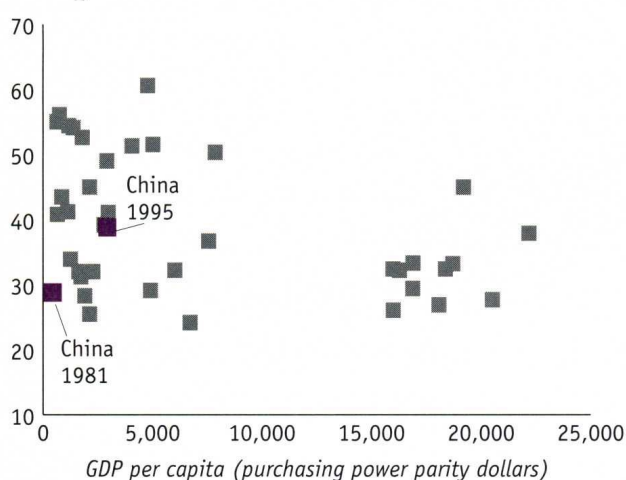
The increase in China's Gini coefficient was by far the largest of all countries for which comparable data are available (figure 1.2). Such a large change is unusual. Levels of inequality vary enormously by country, but

income distributions are strikingly stable over time within a given country (Deining and Squire 1996). When large changes do occur, they generally signal deep structural transformations in the underlying distribution of assets and in their rates of return. Recent examples come mainly from transition economies, but Brazil, Thailand, and the United Kingdom have also experienced substantial increases in inequality.

FIGURE 1.1

Since 1981 China's income distribution has become much less equal . . .

Gini coefficient



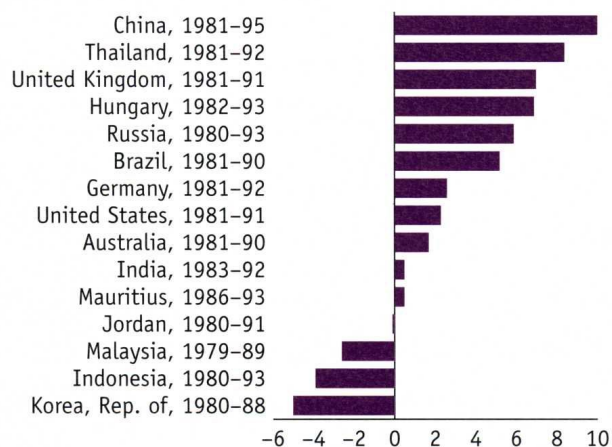
Note: See figure notes at end of chapter.

Source: Deininger and Squire 1996; World Bank 1996f; World Bank staff estimates.

FIGURE 1.2

. . . because of remarkable changes between 1981 and 1995

Change in Gini coefficient (percentage points)



Note: See figure notes at end of chapter.

Source: Deininger and Squire 1996; World Bank 1996f; World Bank staff estimates.

Still, China's recent experience stands out even in this crowd. Not even the transition economies of Eastern Europe and the former Soviet Union registered increases in inequality as large as those observed in China over the past fifteen years. Moreover, some East Asian countries actually saw inequality fall during this period.

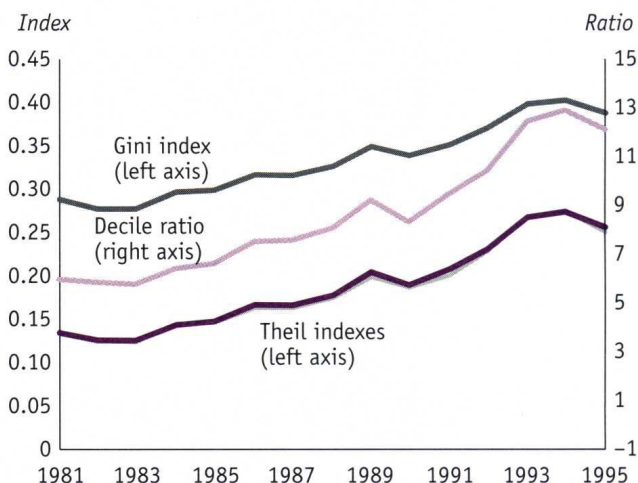
Growing unequal: National trends

Regardless of how inequality is measured, China's income distribution has become more unequal (figure 1.3). This conclusion holds despite the many shortcomings of China's household survey data (box 1.1). The decile ratio (the ratio of the mean income of the top 10 percent of the population to the mean income of the bottom 10 percent) has been rising, especially since 1990, suggesting increasing divergence between the richest and poorest groups.

Since the start of reforms China has experienced three distinct periods in the evolution of personal incomes (box 1.2).¹ Between 1981 and 1984 all segments of society benefited from across-the-board improvements in welfare, with only a small rise in inequality. Between 1984 and 1989 personal incomes stagnated and became increasingly unequal, implying real losses in the standard of liv-

FIGURE 1.3

Other measures of inequality point to the same conclusion as the Gini index, 1981-95



Note: The decile ratio is the ratio of the mean income of the top decile of the population to the mean income of the bottom decile. The Theil indexes (Theil 1 and 2, or mean log deviation) belong to the generalized entropy class of inequality measures, which are decomposable.

Source: State Statistical Bureau data and World Bank staff estimates.

Shortcomings of household survey data—and what this report does about them

This report's analysis of China's income distribution is based on the results of household surveys carried out by China's State Statistical Bureau. These surveys have many shortcomings, but they remain the only source of comprehensive data over a long enough period to assess national trends in the distribution of income (see World Bank 1992 and Chen and Ravallion 1996 for a detailed discussion of problems with rural surveys). The main concerns with the surveys relate to coverage, definitions, and processing after data collection:

- The surveys are based on the registration system (*hukou*) and so do not capture migrants into urban areas without a *hukou*. Few migrants acquire resident status, so this omission is serious and growing.
- Urban and rural surveys are based on incompatible definitions of incomes, which reduces comparability and hinders aggregation into a national distribution.
- The data do not account for spatial differences in the cost of living. Thus neither regional differences within the urban and rural surveys nor national rural-urban differences can be treated systematically.
- Urban household surveys exclude in-kind income such as housing, health care, and education benefits. Also, the surveys appear to be geared toward recording labor income, and so miss many of the newly affluent.
- Summary urban data in the *China Statistical Yearbook* for 1989–95 suffer from aggregation problems that understate urban inequality.
- Until 1990 rural household surveys valued in-kind grain income at official prices, understating rural income considerably. After 1990 and until recently own-grain consumption was valued at the weighted average of official and market prices, but practice varied by province. Both distortions make it difficult to analyze trends over time and across provinces.
- Definitions of *residence* and *income* have changed over time. Urban residency was extended to some periurban areas in 1985, and pensioners were included in income surveys starting only in 1985.

This report did not have access to individual household data except for rural data from four Southern provinces (Guangxi,

Guizhou, Guangdong, Yunnan) for 1985–90 and rural and urban data for Sichuan and Jiangsu provinces for 1990. As a result systematic corrections could not be made to the shortcomings identified above. Instead, partial adjustments have been made in various sections of the report to indicate the magnitude and direction of the resulting effect on inequality. The aggregate effect of these and other necessary corrections cannot be determined with any precision at this time. Further collaboration with the State Statistical Bureau is needed to confirm that the report's findings are robust and to adjust survey design and tabulation methodology for the future. The report's analysis includes the following adjustments:

- The living standards of migrants are discussed only with reference to special surveys on migrant populations and cannot be integrated with the overall income distribution.
- For the most part, national trends are based on an aggregation of rural and urban household surveys into a national distribution without any adjustments in the definition of income or for spatial price differentials.
- Some indicative adjustments help provide a more accurate picture of the components of inequality: mean urban and rural incomes are adjusted to include in-kind incomes using information from the State Statistical Bureau and the four-province rural dataset; and a cost of living differential is introduced to account for higher prices in urban areas.
- The four-province dataset is used to correct for grain pricing, cost of living differentials, and the valuation of housing and consumer durables. This allows for a more accurate valuation of rural incomes, inequality, and changes over time.
- For 1989–95 the report uses urban data aggregated by the Beijing office of the State Statistical Bureau but coming from a subsample of the survey that has consistently higher mean incomes than the published data.
- The effect of in-kind incomes on levels of and changes in urban inequality is investigated using information provided by the State Statistical Bureau for 1990 and 1995.
- The analysis of the determinants of inequality relies largely on available microdata and thus is sensitive to measurement changes.

ing for a large part of the population. Renewed growth in incomes between 1990 and 1995 appears to have reached the poorer (but not the poorest) segments of society but was accompanied by substantial increases in inequality.

Growing out of poverty?

China's record on reducing poverty is enviable. Since reforms started in 1978, China has lifted some 200 mil-

lion people out of absolute poverty. Most of this progress occurred in the early years of reforms, when the introduction of the household responsibility system transformed China's countryside. In the mid-1980s and early 1990s poverty levels stagnated (and increased in some years) despite steady gains in per capita GDP. These trends generated concern about the quality of Chinese growth because increases in inequality that occur because the poor stay poor or get poorer while