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Primary Distribution, Top Incomes and Inequality in China, 1978-2007^{1 2 3}

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Abstract

Most analyses explain the increase in China's overall inequality during the reform period principally by means of the expansion of urban-rural income gap. This paper tries to shed light on a more complex relationship that appears to exist between primary distribution of income, top incomes share, and the Gini index. This relationship is mediated by the same urban-rural disequalizing mechanism existing in the Chinese economy, which is based on the *hukou* system. After presenting the main theoretical contributions that clarify the general relationship among those three variables, we describe that mechanism which has connected them in China during three last decades. As we shall see, there exists a link between the relative impoverishment of Chinese peasants, the consequent flow of rural-urban migration, its depressive effect on industrial wages, the resulting increase in the profits' share, and rising top incomes. The enrichment of urban top income households seems to drive the rise in the urban-rural gap, while labour's loss of share in national income ultimately accounts for the overall increase in the Gini index. The paper ends with a reflection on the ability of the latest policy measures taken by the Chinese government to reverse this pattern of inequality during the current global economic crisis.

Key Words: Functional Distribution of Income; Top Incomes; Urban-Rural gap; Gini Index; Chinese Economy.

JEL: O11, E25, P25, E64, D31,

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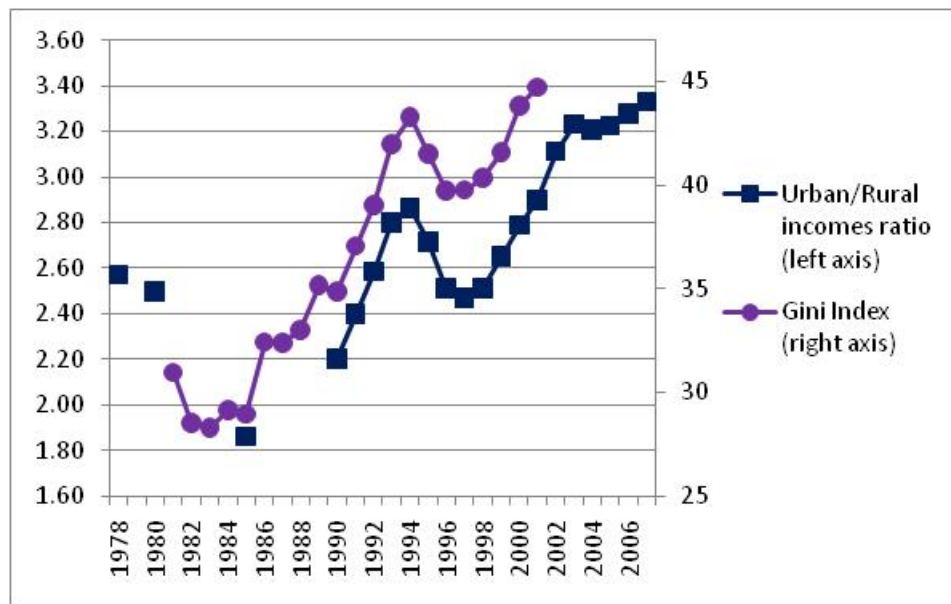
³ A previous version of this work can be found (in Spanish) in Molero Simarro (2011a).

Introduction

China's growth rates (averaging 9.9% between 1978 and 2007⁴) have allowed the Asian country to become the second largest economy in the world since 2010. However, those rates have also been accompanied by an unprecedented rise of income inequality. The Gini index of income inequality has increased from 31.0 to 44.7⁵. According to Barry Naughton, "There may be no other case where a society's income distribution has deteriorated so much, so fast" (Naughton, 2007: 218). Not surprisingly, "in the course of two decades China has gone from being one of the most egalitarian societies about as equal as Japan, to being more unequal than the United States" (*ibid.*).

This increase in income inequality has attracted wide attention in recent decades. Many studies attribute it to varying general factors, mainly related to urban-rural inequality (see, for example, Li y Zhang, 1998; Wu and Perloff, 2005; Benjamín, Brandt, Giles, Li, Li and Wang, 2007; Liu, 2010). In fact, the relationship between urban-rural income differences and overall inequality can be easily contrasted by reference to the parallel evolution of the urban-rural gap and the Gini index (Figure 1).

Figure 1: China's Urban-Rural Inequality and Gini Index (1978-2007)



Source: NBS and Ravallion and Chen (2007)

⁴ Own calculations based on the data from the National Bureau of Statistics of China (NBS): *Statistical Yearbook*, 2009.

⁵ Data from Ravallion and Chen (2007).

Other studies have deepened these analyses by taking more complex explanatory causes into account (Yu and Wu, 2008; Zhou, Harrel and Hua, 2008; Qian, 2008). However, along with Ravallion and Chen (2007), whose data we use here, the research of Khan, Riskin et al. (Khan, Griffin, Riskin and Zhao, 1992; Khan and Riskin, 1998 and 2005) is still the reference point on the topic since theirs was the only research based on their own survey of Chinese household incomes, conducted in 1988, 1995 and 2002 by the Chinese Academy of Social Sciences (CASS).

The figures for households' incomes obtained by Khan and Riskin's study differ from those of other studies based on the official NBS surveys. Khan and Riskin present a figure of real household income growth lower than that calculated by using the NBS data, mainly since the latter "exclude from household income numerous elements that standard accounting elsewhere normally includes" (Khan and Riskin, 2001: 56). Indeed, China's population would have suffered a decrease in those elements (typically non-cash subsidies, widely received during the previous Maoist period), which, if not taken into account, would "seriously bias estimates of distribution of income and poverty" (*ibid.*)⁶.

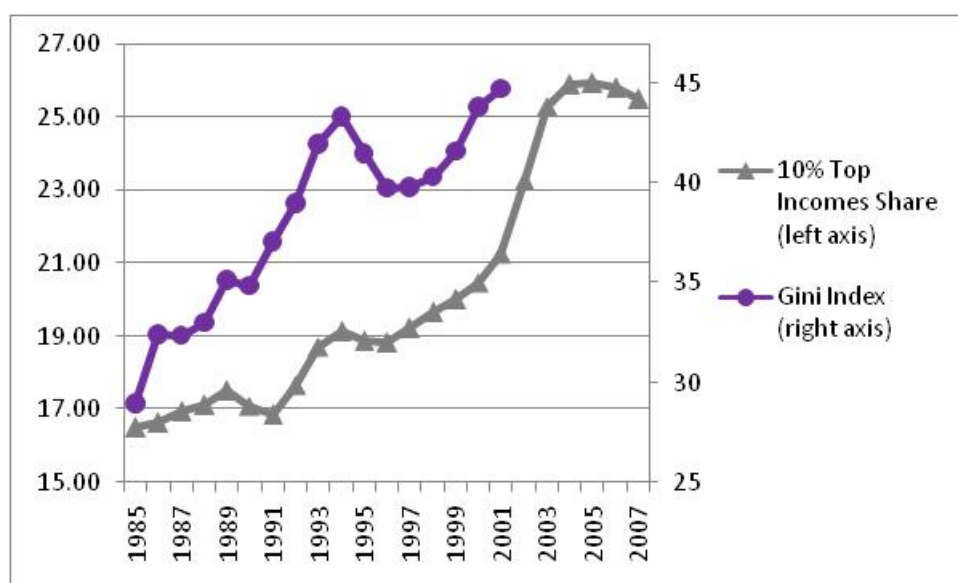
In any event, Khan and Riskin's principal conclusions coincide with the other studies. According to their analysis, the increase in China's Gini index is due largely to an expansion of the inequality between urban and rural areas. Khan and Riskin's figures show that the overall Gini index is higher than the Gini indexes for rural and urban areas taken separately (Khan and Riskin, 2005). Although there is a more equal income distribution in rural areas than in urban, inequality has also increased in the former. Specifically, according to Khan and Riskin's study, this increase is explained by a change in the composition of total income that has favoured more "disequalizing" components of household's incomes (especially wages). By contrast, they maintain that urban inequality has increased because of a worsening distribution of most income components. In addition, the concentration of investment in certain areas has also aggravated imbalances between interior and coastal provinces.

However, Khan and Riskin draw attention to an important issue that points to unresolved questions about China's inequality: another existing gap between the annual growth rates of GDP and personal income. They state this divergence "is due mainly to macroeconomic policies affecting the distribution of incremental GDP among households, government, and enterprises, and between consumption and accumulation", related to the "rise in the ratio of investment to GDP", which would need "a redistribution of resources away from households and in favour of non-household entities" (Khan and Riskin, 2001:105) to enable the Chinese economy's high growth rates.

⁶ According to Wang (2008: 6) during the Maoist period "[w]elfare allocation was thus an important feature of the redistributive economy, and income was not the most important measure of economic well-being".

In fact, the dramatic accumulation of capital during the reform period has been financed primarily by savings from corporate profits (Kuijs, 2005; He and Cao, 2007, Li and Yin, 2009). The increase in these profits may have been achieved at the expense of the workers' incomes. The consequent decline of labour share in national income would have engendered, as other authors have found, a parallel loss in households' share of institutional income distribution (Bai and Qian, 2009). According to a 2010 OECD study (2010), two thirds of Chinese urban household incomes in 2008 were explained by wage share. The larger share of national income accumulated by companies would have enabled China's high rates of investment and growth. However, our view is that they would have also provoked an increase in the percentage of income hoarded by the richest segments of the Chinese population, thereby creating a relationship between their enrichment and overall national inequality (Figure 2)⁷.

Figure 2: Top Incomes and Gini Index



Source: Author's calculations based on Urban Households Income Survey and Ravallion and Chen (2007)

As we shall see, the meagre improvement of rural incomes since the mid-1980s, and its push effect on rural-urban migration would explain the restrained growth in industrial wages. The increase in

⁷ Here we use the evolution of top 10% incomes share as reference. However, it is important to notice that the share of the top 1% incomes would have grown at a rate of over 120% (Piketty and Qian, 2009). That rate would be even higher if we bear in mind the results of the latest research which find a large amount of hidden household income which would multiple the ratio of the income of the richest 10% of household relative to the poorest 10% until reaching a value of 65 times (Wang and Woo, 2010).

Chinese workers' wages well below the growth in their productivity⁸, together with the relative impoverishment of Chinese peasants, would allow the increase of profit share in national income, and the consequent in-depth enrichment of top income households. Thus, complementing the prevailing view, which explains inequality uniquely in terms of the evolution of the urban-rural gap, those findings help to establish a more thorough relationship between the regressive patterns followed by both primary and personal distributions of income.

To justify our perspective, the next section starts by presenting the main theoretical contributions explaining the general relationship between the primary (labour-capital), and personal (households) income distributions. Later, we review the main data sources available for distributional variables and clarify the differences in other studies' data with ours. In the third section, we show the principal relationships that clarify the connection between economic growth and income inequality in China's economy between 1978 and 2007. This paper's conclusion discusses possible resistance to the transformation of this distributive mechanism and, consequently to the achievement of a more equitable income distribution that would allow China to reorient its growth model to the internal market and thereby surmount the current global economic crisis.

1. The relationship between primary and personal distributions of income

In recent years various authors (see, for example, Lindenboim, 2006; and Atkinson, 2009) call attention to a neglected topic in applied economics analysis: the evolution of functional, so-called primary, distribution of income, i.e. the distribution of national income between profits and wages. On the basis of David Ricardo's classic statement that "the laws which regulate the distribution" are "the principal problem in Political Economy", Atkinson (2009: 4) argues that factor shares are "making a comeback" in economics. This revival would be explained by the fact that since 1970s workers' share of national income has suffered a deep drop in most countries, both developed and developing, as the IMF (2007) and the OECD (2007) attest. This seemingly structural change would reject the statement that factor shares are constant (Garrido, 2005; Carter, 2007)⁹, as Nicholas Kaldor's stylized facts claimed and

⁸ With regard to this last point, it is important to notice that, not only did urban-rural increase dramatically during this period, but in urban China "income inequality among all residents also increased rapidly, nearly doubling within about a decade" (Wang, 2008: 6). In our view, this would be explained by a transfer of rent from wage earners to proprietary incomes.

⁹ A precedent for this critique can be found in the work of Kravis (1959).

Robert Solow had already denied in 1958. Thus, all this gives Atkinson (2009: 5) three reasons for studying factor share evolution:

- “to make a link between incomes at the macroeconomic level (national accounts) and incomes at the level of the household;
- to help understand inequality in the personal distribution of income;
- to address the concern of social justice with the fairness of different sources of income”.

Finally, analysis of that link between factor shares and household incomes could also aid in understanding the relationship between economic growth and income inequality.

This relationship between growth and inequality has usually been explained by using the Kuznets curve, positing that the Gini index would move at the pace of economic development, increasing during the first stages of industrialization and decreasing afterwards. This claim is also based on the widespread idea, originated by Arthur Lewis, that the unlimited supply of rural labour plays a role in limiting the growth of industrial wages during the first stages of the development process. However, this narrative, typically claimed to be a process led by demographic trends, forgets, first, that the evolution of rural-urban migration is in fact determined by various factors affecting both rural incomes and migration decisions (including in China’s case, government policies concerning grain prices and migration controls¹⁰); second, that even when that transfer of workers from the agricultural to the industrial sector is finished (the “Lewis Turning Point”) personal income distribution is also determined by sociological and political factors affecting the general distributive conflict between businesses and workers.

In this sense, other authors have argued in recent years in favour of a central relationship between primary and personal distribution to explain the evolution of general income inequality. These authors have stated that relationship both theoretically (Glyn, 2009) and empirically (Daude and García-Peñalosa, 2007)¹¹. According to them, in any economy a lower (higher) share of wages in national income tends to generate a lower (higher) share of middle and lower income households in the distribution of disposable income, thus raising (lowering) the Gini coefficient of personal income distribution. At the same time, a higher (lower) share of profits results in a higher (lower) share of the disposable incomes of the richest households, thus raising (lowering) that coefficient. Indeed, capital

¹⁰ Concerning debates on the Lewis turning point in China it is important to bear in mind that “China’s unlimited supply of labour was more a consequence of policy than a natural precondition of its development” (Hung, 2009: 21).

¹¹ Giovannoni (2010) also found an empirical negative incidence on poverty of the decreasing labour share on national income, though he stresses the relevance of general economic policies and specific redistributive systems, to explain the evolution of both labour share and poverty index values.

share is linked to proprietor income, which accounts for a higher proportion in the top 1% and 10% incomes than in the incomes of lower household percentiles and deciles.

Moreover, in recent years a relevant line of research has been opened on the evolution of the share of the richest population groups in household distribution in various countries (Atkinson and Piketty, 2007 and 2010; Atkinson, Piketty and Saez, 2011)¹². Empirically, the main finding of that research is a U-shaped pattern in the evolution of top incomes shares during the twentieth century, dropping in the first half before increasing during the second, and concentrating gains within the top percentile of disposable income of most countries under study. Theoretically, these authors have reviewed several possible explanations for this tendency: political economy, financial crises, “globalization”, and progressive taxation. In any event, a link can be traced between the evolution of top incomes and overall distribution to explain how the higher share of top incomes in disposable income worsens general income inequality. Leigh (2007: 628) found a statistically significant relationship between top incomes shares and other inequality measures, such as the Gini Index.

If we link these and earlier findings, it is possible to relate the evolution of the Gini index to the pattern of primary income distribution, through understanding top income progression. In China the relationship between those variables is linked to a specific control mechanism of the rural-urban migration. However, a general relationship between profit share and top incomes, as well as between the former and the Gini index can also be found, at least for the reform period under study.

2. Statistical Series Compilation and Comparison

This analysis uses several data sources. First, for the series of the primary, so-called functional, distribution of income it uses the Hsueh and Li data (1999) as well as GDP by Region Table provided by the NBS¹³. Second, for top incomes, the study uses NBS data: China’s Households Income Survey yearbooks. Concerning this last source, it is important to note that, after scrutinizing the survey’s quality, Bramall (2001) concluded that it “still provides too fragile a basis for firm policy conclusions. (...) Both the extent of the increase and its underlying causes are still very far from clear” (Bramall, 2011: 698), even after taking into account the adjustments made by the Khan and Riskin’s research.

There are other problems with the data. First, China’s estimates of top income shares are based on survey, not tax data, which usually are the main source for calculating these shares. According to

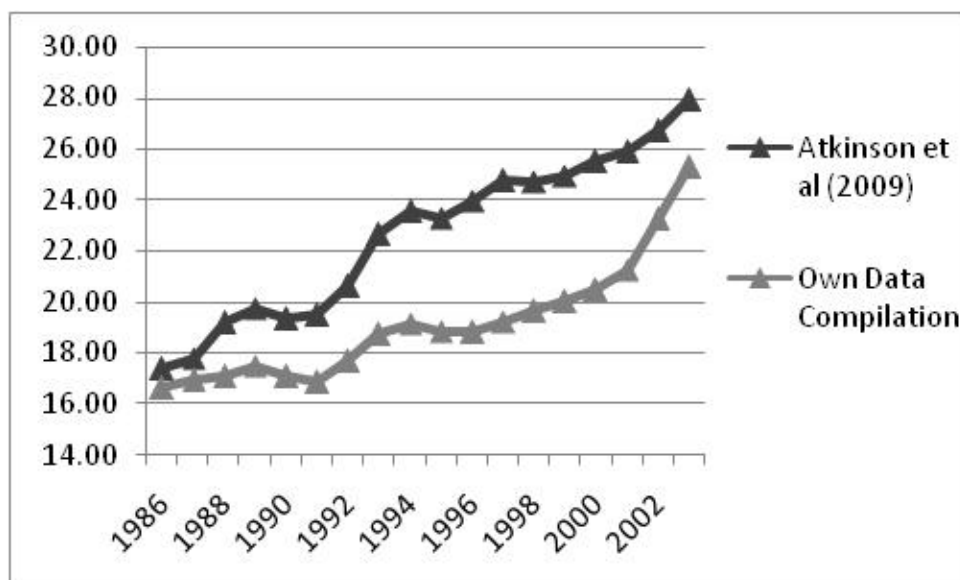
¹² See also Leigh (2009). A precedent for these studies can be found in the work of Kuznets (1950).

¹³ On the choice and recalculation of this series and the comparison with other calculations see Molero Simarro (2011b).

Leigh (2009: 7) “Series derived from taxation data are more likely preferable to survey data, since surveys are known to undersample high earners (...) and because taxation data allow one to study the income share of very small groups (...) which would be represented only [by] a handful of individuals in a typical survey”. As cited earlier, the Wang and Woo (2010) survey of China’s grey income and its distribution finds a severe underreporting of high-income households’ incomes in the official surveys. Although it is possible to obtain levels and income distribution by quintiles for the period 2005-2008 in the Wang and Woo paper, it is not possible to construct an accurate series for the whole period under research. Consequently, we are compelled to use official data, subject to the above reservations.

Second, it is necessary to note that our compilation of urban household income deciles differs from the World Top Incomes Database developed by Alvarado, Atkinson, Piketty and Saez¹⁴. This difference could be explained by Piketty and Qian’s¹⁵ computations with the NBS’ Urban Households Income Survey, which here we use in gross terms (Figure 3). As long as the gap between both series widens during most of the period under research, it is important to be aware that both absolute levels and the speed of the increase in top incomes shares may be underestimated in this work. However, the shared general rising trend points to similar conclusions. Indeed, it would reinforce our claims.

Figure 3: Comparison of China’s Top 10% Urban Households Income Share Data Compilation



Source: World Top Incomes Database and Own calculation based on Urban Households Incomes Survey

¹⁴ For China, this database relies on Piketty and Qian (2010), whose data are available in the data appendix of Atkinson, Piketty and Saez (2009): the same data set available in the World Top Incomes Database.

¹⁵ See previous footnote.

Third, as OECD (2010: 138) explains “[t]he published data on the distribution of household incomes in China is sparse. For urban areas, it is limited to showing average incomes in the bottom 5 and 10% of the income distribution and in the five quintile levels for urban households. For rural households, the data is presented differently, as the proportion of people with nominal incomes between different levels. The latter intervals are changed only infrequently despite a generally-increasing price level. In addition, these presentational differences make it difficult to add the rural and urban income distributions to obtain a national income distribution. In fact, the National Bureau of Statistics never presents data for the national distribution of income”. To overcome these problems, the OECD adopts the method developed by Chotikapanich, Rao and Tang (2007) to transform urban and rural separated data into a continuous national household income distribution series. Unfortunately, it has been impossible to access that work, so we present urban household income separately. Although this situation limits analytical coverage, it may be justifiable *a posteriori* by the finding that the rise in the share of urban top 10% incomes’ households is a principal factor in the overall increase in China’s inequality.

Finally, it is necessary to be aware of the disparities between the different accountings of the Gini index published to date. These are partly attributable to the fact that the NBS has not published new official data for this variable since 2000, when it reported a value of 41.2 for the index. For example, in the series compilation available in the World Income Inequality Database of UNU-WIDER, the Gini index ranges from 16.0 to 29.5 for 1977-1980, and from 37.2 to 46.9 for 2002-2004. Compared to the original sources of the UNU-WIDER database’s series, the data series presented by Ravallion and Chen (2007) is longer and more comprehensive. Based on NBS’ both Rural and Urban Households Income surveys, this World Bank’s research reports an increase in national inequality from 31.0 to 44.7 between 1981 and 2001, or from 28.0 to 39.6 if their adjustment for the differences in urban and rural costs of living is taken into account (*op.cit.*: 20)¹⁶. The surveys do not revise these latest figures when

¹⁶ Comparing their own with other measurements, the OECD (2010: 139) states that its Gini estimates (obtained using the Chotikapanich, Rao and Tang (2007) method, already cited) “are substantially lower than previous estimates of inequality in China. In particular, they are about one fifth below those produced by Ravallion and Chen (2007). These authors had access to unpublished tabulation from the National Bureau of Statistics which may or may not explain part of the difference. Another difference pertains to use of different spatial price deflators. Ravallion and Chen calculate the cost of purchasing a basket of food typically consumed by households with incomes between the 15th and 25th percentile by province. This expenditure is then scaled to allow for non-food consumption. The resulting poverty line is turned into a price deflator by using the provincial rural and urban price indices. As the authors state, this is not an ideal procedure for measuring provincial cost of living indices for the average household. In contrast, the estimates presented here use provincial urban and rural price indices based on the consumption pattern of the average consumer”.

they adjust poverty figures to new purchasing power parity calculations (Ravallion and Chen, 2008); moreover, other sources available provide both lower and higher figures¹⁷. Accordingly, this study uses the original Ravallion and Chen data.

3. Dynamics of Growth and Inequality during the Chinese Economic Reform

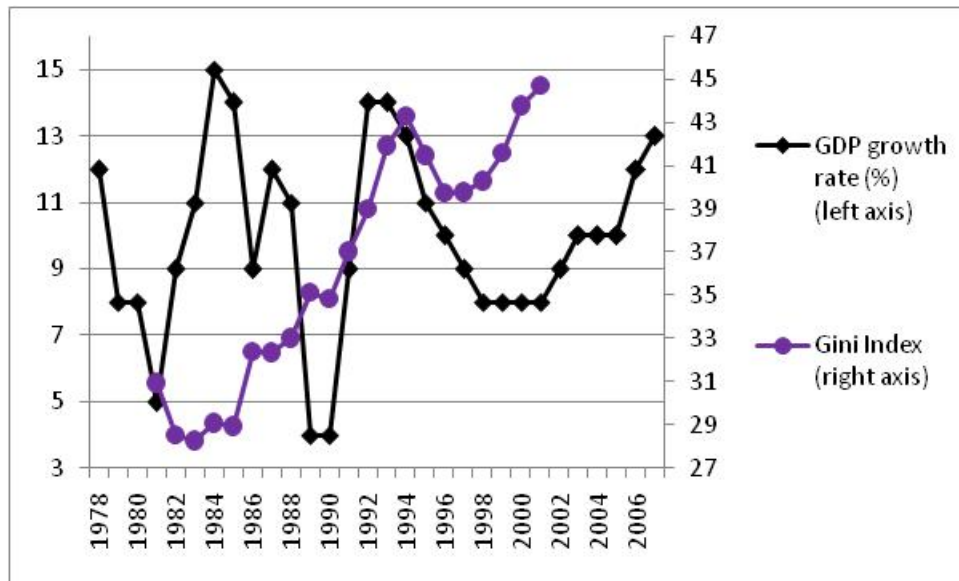
As shown in Figure 4, China's high rates of economic growth have been accompanied by a continuing increase in income inequality during most of the period of economic reform. Only at the beginning of the period, between 1981 and 1985, did growth allow inequality to decrease. This decline was due to the favourable impact of rural reforms which introduced "household responsibility systems", enabling an increase of farmers' income and a corresponding decrease in the urban-rural gap. Thus, the Gini index, which at the beginning of the reform period was already at a comparatively low level, fell to a record low value of 28.3 points in 1983. Since then, however, the reform measures restimulated urban industrial development, widening the gap once again and putting growth and inequality on a relatively parallel trajectory. The later decreased markedly when growth fell between 1994 and 1997. During 1997-2001 growth rates were still at low levels, as an effect of the Asian Crisis. However, inequality continued to grow, because, among other factors, the disequalizing effect of the privatization of state enterprises.

They authors conclude that "[a]lthough inequality has increased markedly during the past two decades, especially in urban areas, the Gini coefficient does not appear that high by international standards (Figure 5.1 above). Overall, China's national Gini coefficient is below that of most major emerging market countries. The urban coefficient is lower than that in a number of OECD countries, especially once allowance is made for the fact that the Chinese data is measured on a per capita basis and the OECD data on an equivalence basis" (OECD, 2010: 141).

It can be noted, however, that the values obtained through Khan, Riskin et al., research on China's inequality, (op. cit.) present figures that are even higher than those of Ravallion and Chen: 38.2 for 1988; 45.2 for 1995; 45.0 for 2002. Even the latest research of Li, Luo and Sicular (2011) give a value for 2007 that ranges between 48.3 and 49.1; the difference depends on including rural migrants living in cities or not.

¹⁷ See previous footnote.

Figure 4: China's Economy Growth and Inequality (1978-2007)



Source: NBS and Ravallion and Chen (2007)

As will be demonstrated, behind China's economic growth stand very high and sustained rates of investment. The investment itself has been financed by firms' profits. At the same time, the profits have been realized through a distributive mechanism that has enlarged the urban-rural gap. This has made possible the enrichment of the richest Chinese urban families. Finally, growth has been achieved on the basis of income inequality.

Unlike the experience of Eastern European countries, where "shock therapies" accomplished a rapid transition from planned to market economies, the Chinese transition has been gradual¹⁸. The reform was launched with the initial aim of improving the productivity of both agriculture and industry through the changes in management techniques. In the countryside, the household responsibility systems replaced the organization of production by the rural communes¹⁹. In the city, state enterprises were given greater autonomy by planning agencies to make decisions regarding the productive process. In both cases, an incentive mechanism was launched to permit farm families and industrial companies to sell on the open market all production that exceeded the compulsory quotas sold to the state. First, in the agricultural sector and, then, in the industrial, production and productivity increased considerably, fulfilling the reform's initial goal.

¹⁸ On the differences of Eastern Europe and China's transition processes see Nolan and Ash (1995) and Walder (1995).

¹⁹ See Oi (1999).

At the same time, the economy's price system was also modified by introducing two-tier pricing, with state-planned and market prices coexisting²⁰. As long as the first prices tended to remain below the second, both rural families and industrial firms began to increase sales on the market, until market prices ultimately became the main regulator of economic relationships²¹. Meanwhile, the world market began to gain importance in setting prices as China moved increasingly towards external openness. This process began with the creation of "special economic zones" for foreign investment²² and culminated with country's 2001 entry into the World Trade Organization²³. At the same time, the enterprise reforms were deepened²⁴. First, a labour reform gave autonomy to State Owned Enterprises (SOEs) to hire and fire; many workers were laid off²⁵. Second, a privatization process was undertaken since 1997, aimed at "grasping the large and letting the small go". These reforms caused the gradual disappearance of the *danwei* system²⁶. The resulting loss of employment protection allowed market pressure on prices to impact wages directly²⁷.

Since then, the relationship between the countryside and the city has become the key to pass on that pressure on wages. During reform's early years, productivity improvements in rural areas were accompanied by increasing prices of agricultural products promoted by the State. This helped to substantially improve the living standards of farmers, thereby reducing inequality between rural and urban areas. Gradually, however, the terms of trade between agricultural and industrial products turned again to favour the latter²⁸. Rural industrial enterprises experienced a strong growth at the beginning of the reform process, generating many job opportunities. Nevertheless, industrial development moved increasingly to coastal cities. Finally, the usufructuary use of collective land property enabled rural families to exploit their own plot of land and earn a basic income. Nonetheless, the growing urban-rural gap created an intense migration flow from rural villages to the cities. Migrants became the labour force that enabled the expansion of urban industry²⁹.

The Maoist era had established a system for controlling internal population movements. The *hukou*, or household registration system, made it practically impossible for a rural dweller to obtain an

²⁰ See Chai (1997).

²¹ See Naughton (1996).

²² See Crane (1990).

²³ See Lardy (2002).

²⁴ See Lin and Zhun (2001).

²⁵ See Solinger (2002).

²⁶ See Lü and Perry (1997).

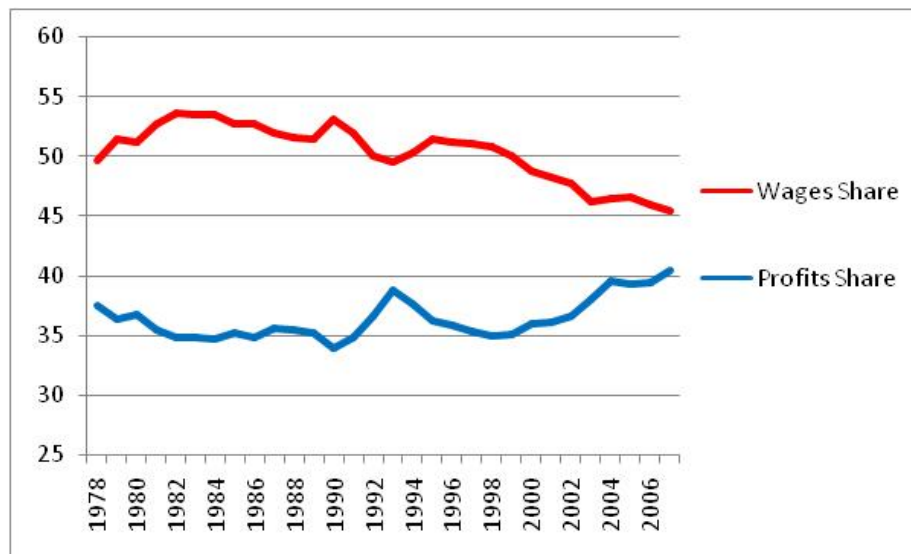
²⁷ See Larus (2005).

²⁸ See Knight and Song (1999).

²⁹ See Wen Tiejun (2008).

urban residence permit. Its goal was to tie the rural population to the land and to extract resources for industrialization. The last three decades have transformed the economy's operating logic, but the *hukou* is still in effect³⁰. "Undocumented" rural migrants to the cities are deprived of public services and legal protection. The tide of undocumented migrants in the coastal cities³¹ has held industrial wages to a lower rate of increase than productivity growth. Consequently, since mid-1980s, wage share in national income has declined continuously, dropping to 45% in 2007 (Figure 5).

Figure 5: China's Primary Distribution of Income



Source: Own calculations based on Hsueh and Li (1999) and NBS

That level of the wage share is lower than that found in other developing economies. This fact could explain the huge inward flow of foreign direct investment (FDI) into the Chinese economy. However, it is worth bearing in mind that from 1996 to 2004, FDI accounted on average for only 10.6% of the Chinese economy's total gross capital formation³². Actually, the investment rate has achieved a thirty year average of 37.5% on GDP, a very high figure by international standards, thanks to China's high savings rate. Contrary to most analysts' claims, profits from Chinese profits are the main source of these savings. Thus, productive investment in China is largely driven by reinvestment of those profits

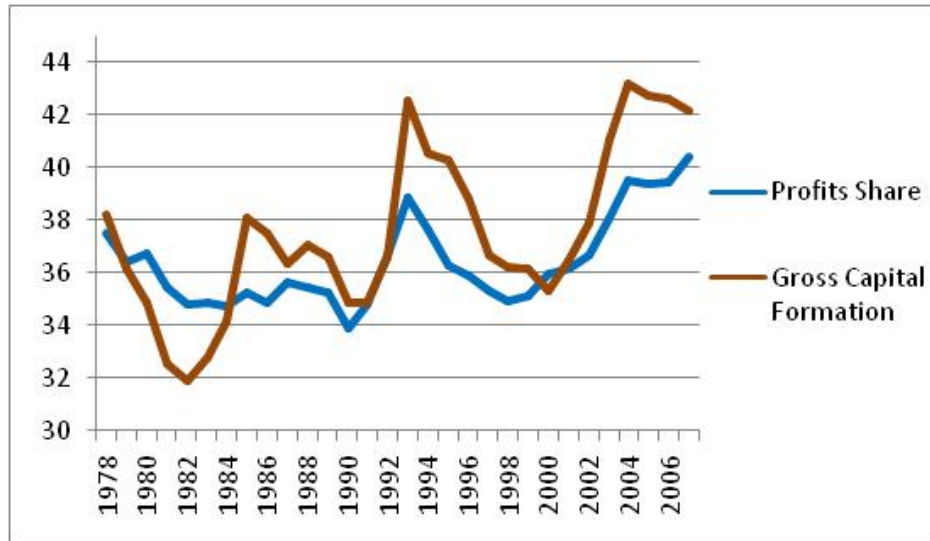
³⁰ According to Bramall (2008: 527) "the advocacy of labour migration by many Chinese policymakers is driven much by a desire to raise the profits of urban industry, and foreign enterprises invested in China".

³¹ See Knight and Yueh (2009).

³² Data from UNCTAD: *World Investment Report*, 2011.

(Figure 6). Indeed, the main function of the distributive mechanism explained above has been to ensure profits are sufficiently high to sustain the intense accumulation process.

Figure 6: Profit's Share and Investment

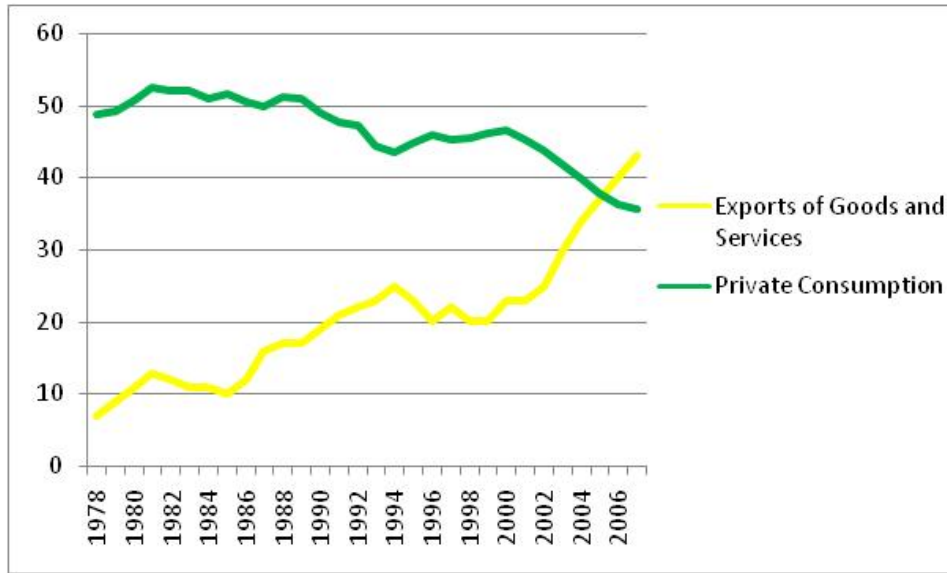


Source: Own calculations based on Hsueh and Li (1999) and NBS, and NBS

The wage restraint allowed by China's economy distribution scheme is also behind the high international competitiveness of Chinese exports. Net exports maintain a low level during most of the period studied here, exceeding 5% of GDP only since 2005. Total exports, however, have been an important demand side component for explaining growth at least since the early 1990s. Household consumption has gradually lost its relevance because of the worker's falling participation in national income. Thus, exports have become the main source of final consumption demand (Figure 7). Investment can be considered the main engine of growth (Figure 8). However, it is the interaction between those components, investment and export demand, which best explains the economy's expansion. As shown above, internal reinvestment of profits is more relevant than foreign investment flows in explaining accumulation rates. Nevertheless, the Chinese economy has become deeply dependent on external markets during recent decades³³.

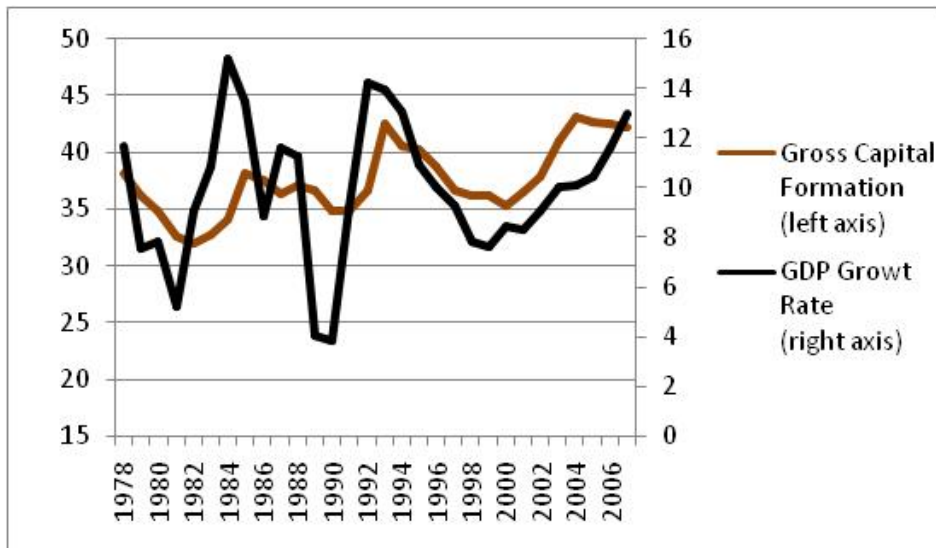
³³ See Zhu and Kotz (2010).

Figure 7: Internal and External Demand



Source: NBS

Figure 8: Investment and Growth

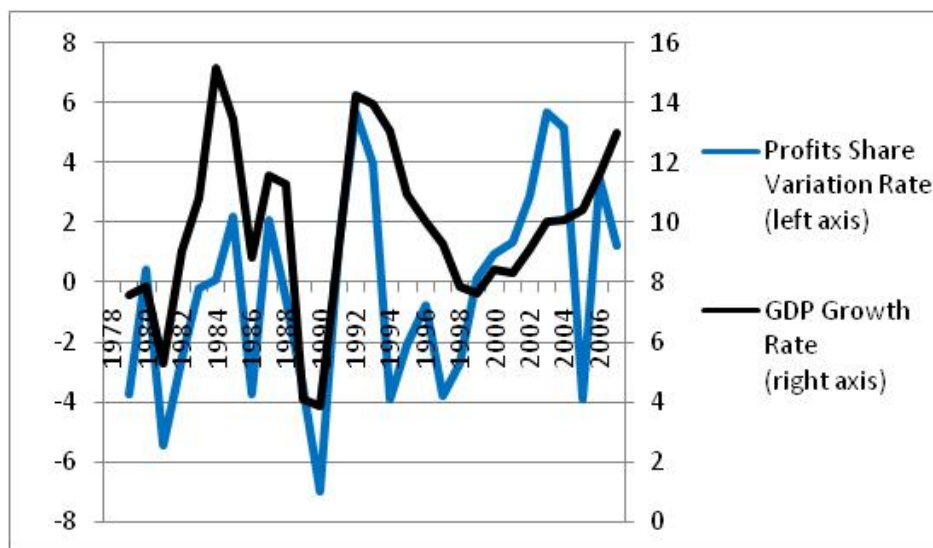


Source: NBS

Therefore, to make the Chinese economy's fast-paced expansion possible, it has been essential that wages grow more slowly than productivity. This has been achieved through the downward pressure on urban wages exerted by undocumented rural migrants. That phenomenon has generated: first, profits sufficient to ensure an average 37.5% rate of investment; and second, competitive price levels to allow Chinese export companies to conquer the world market. Finally, a pattern of "profit-led" growth

has been set according to which the Chinese economy's expansion has followed the evolution of profits share in national income. When this share has increased, growth rates have done the same. When profits have lost share, growth rates have slowed down (Figure 9)³⁴.

Figure 9: Profit-Led Growth

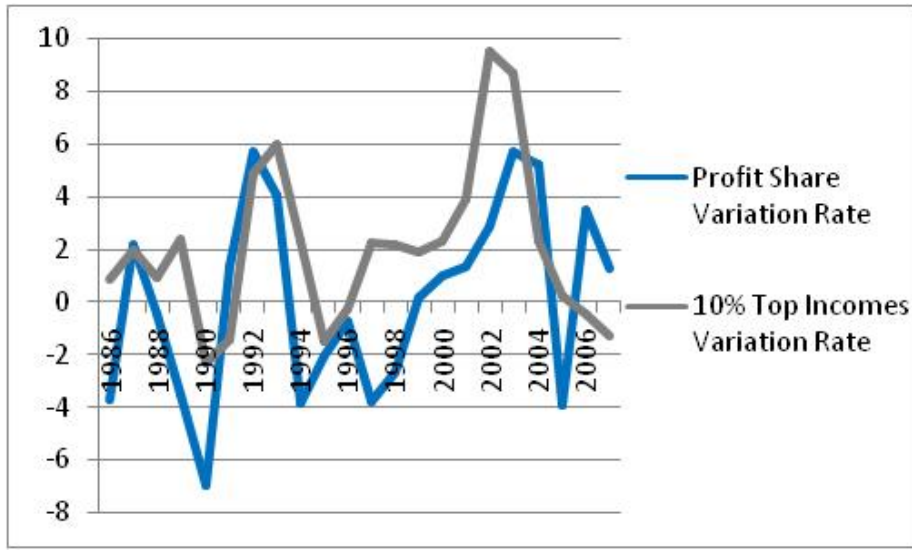


Source: Own calculations based on Hsueh y Li (1999) and NBS

Following this growth pattern, China has become the world's second largest economy. At the same time, however, conditions have been also created to fuel overall inequality (Figure 4). As stated above, limited improvement in rural living conditions has pushed out rural workers, thereby holding down urban industrial wage increases. The share of wages in national income has clearly fallen; that of profits has risen (Figure 5). According to the theoretical contributions presented here, higher share of profit in primary distribution results in higher share of the incomes of the richest households in household distribution of income. In China the higher amount of income appropriated by both state and private enterprise has caused an increase of the richest 10% of the Chinese population share in disposable income. Effectively, the increase in capital share has driven the increase in top 10% incomes share (Figure 10).

³⁴ See Molero Simarro (2011) for examination of that pattern of principal growth relationships.

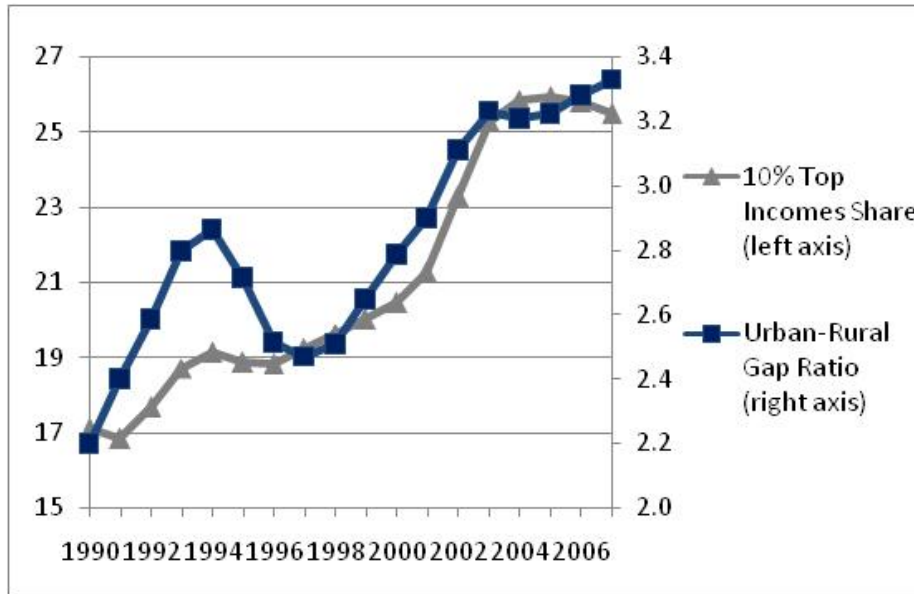
Figure 10: Profits Share and Top 10% Incomes



Source: Own calculations based on “Urban Households Income Survey”, Hsueh and Li (1999) and NBS.

Rents have been channelled from firms’ profits to the richest families’ incomes. However, the mechanism through which those funds have been conducted is not completely clear. On one hand, benefits distributed as dividends are not the norm in large Chinese enterprises. On the other hand, according to what Wang and Woo (2010) deduct from their figures, corruption would be spread throughout the country. Nevertheless, *a priori* corruption is not likely able to mobilize sufficient resources to explain such an increase in top incomes. Thus, a deeper knowledge of the phenomenon is needed to explain it more completely. In any event, the existing growth pattern has increasingly benefited the richest segments of the urban China society. This development may ultimately be a principal factor in the growing urban-rural gap (Figure 11).

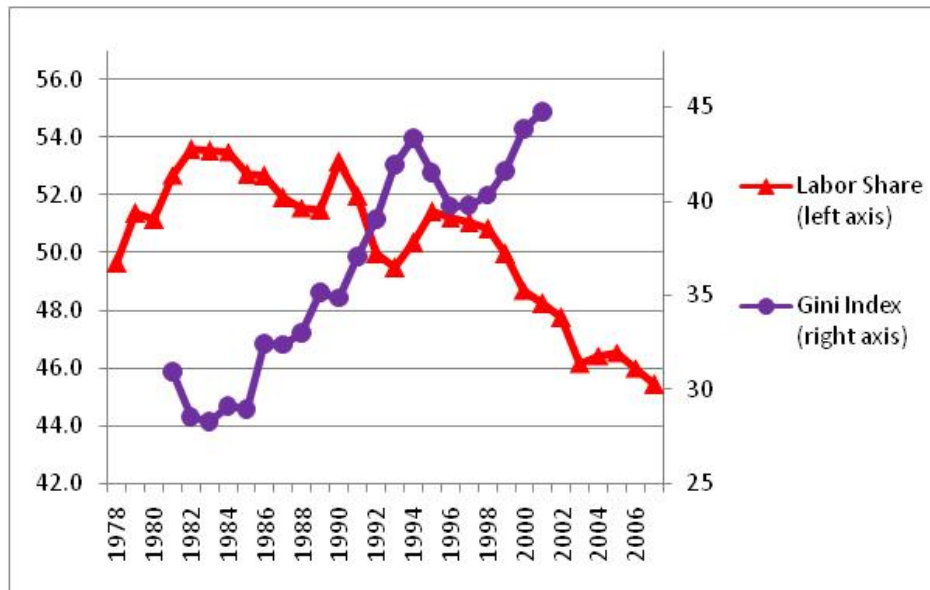
Figure 11: Top Incomes and Urban-Rural Inequality



Source: Own calculations based on Urban Households Income Survey and NBS.

Historically, the relationship of uneven development between rural and urban areas arises among economies at different levels of development. The stagnation of living standards in primary economies allows a process of growth that benefits their industrialized trading partners. In China this relationship has been established within the borders of a single country; the countryside works to enrich the city. Moreover, since urban industrial workers also pay for the apparent enrichment of business proprietors, urban inequalities have also grown. Indeed, the evolution of labour share may ultimately account for the overall rise in China's inequality (Figure 12). Finally, this inequality has become a distributive conflict between the richest urban households against peasants and urban workers.

Figure 12: China's Primary and Personal Distributions of Income (1978-2007)



Source: Own calculations based on Hsueh and Li (1999) and NBS, and Ravallion and Chen (2007)

Conclusions

In summary, the success of China's economic reform has been based on a disequalizing mechanism made possible by the internal control of rural-urban migration. That mechanism allows companies (SOE and private, Chinese and foreign) to increase surplus appropriations, in order to maintain high investment and economic growth rates. The mechanism also allows the richest population decile to hoard a higher proportion of disposable income. This ultimately explains the increase in urban-rural inequality, meanwhile the loss of wages' share explains the general increase in the Gini coefficient.

It is necessary to improve data compilation and treatment to overcome the deficiencies noted in Section 2. In addition, future research could analyze the relationship between rising inequality and reduction of poverty claimed by some researchers, notably Ravallion and Chen (1999, 2007 and 2008). Most poverty reduction (which these authors had to revise downward after reviewing the rural inflation statistics) occurred during reform's first years, when inequality also declined through improved rural living conditions. However, both the loss of access to basic services that peasants suffered as a consequence of the reform, and the later expansion of urban poverty because of rising inequality would have weakened the reform's positive impact on poverty.

It is often claimed that the trend to greater inequality could be palliated by a mix of redistributive policies, which would then inflect the Chinese Kuznets Curve upward. This is not only the

view of some academicians (Riskin, 2007; Wong, 2007), but also of leading international institutions working in China (World Bank, 2003; UNDP, 2005 and 2008). Following their advice, the Chinese government has widened the scope of welfare assistance in both rural and urban areas in recent years (Herd, 2010: 10-12). The regressive taxation system was modified by the 2006 abolition of the agricultural tax. A new Labour Contract Law was adopted in 2008. A Social Security Law was approved in 2011. In addition, the 12th Five Year Plan (2011-2015) has called on provincial governments to increase the minimum wages to 40% of the average wage. These measures seek ultimately to develop “a structural reform to rebalance the sources of growth” (ADB, 2012: 133). In the meantime, domestic demand is being stimulated by means of a 4 trillion yuan fiscal package approved in 2008.

Thanks to these measures, Chinese economy has been able, in the short term, to maintain high, if declining, growth rates. Paired with a probable market intervention to raise grain prices, the effect has been to increase rural relative to urban incomes. The resulting reduction in rural-urban migration flows has caused coastal businesses to complain of labour shortages. Indeed, according to some accounts the wages of migrant urban workers may have increased at high rates from 2008 through 2010 (Cai, 2011). At the same time, worker and peasant struggles have surfaced during the last five years. These range from coastal factory strikes demanding improved conditions and remuneration to village protests against land expropriations by corrupt local governments. New methods of organization have succeeded in achieving these objectives, at least in part (Au and Bai, 2012).

All this would point towards a transformation in the Chinese growth model, perhaps even in the country's social structure. However, some doubts arise. First, despite signs of improvement in private consumption, investment remains the main contributor to growth, throwing into question the alteration of demand-side growth sources. Second, an externalization process towards the west of the country is already under way; regardless of the reduction of provincial inequalities, this would enable low-wage industries to reproduce their classic labour relationships scheme. Third, spreading business resistance to the implementation of the new Labour Law is pressuring the Chinese government to weaken its provisions. The outcome, finally, will depend on the economic strategy the new Party leaders elected in the 18th National Congress of the Chinese Communist Party: will they transform the pattern of growth and distribution or not? In either case, the result will have important implications for the world economy and also, very probably, for the pattern of global inequality.

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