

Inclusive Growth and Poverty Eradication Policies in China

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1. Introduction

This paper reviews China's successful record of poverty reduction and, to a lesser extent, inclusive growth, and the strategies China adopted to achieve both. China's record of poverty reduction is nothing short of spectacular, achieving dramatic reductions in only a short period of time. On the other hand, income inequality has remained a much more serious challenge, and is likely to require much greater effort over longer time horizons. However, it appears that "structural inequality" is beginning to ebb, giving one optimism in expecting that total inequality may also begin to be on a downward trend.

Before reviewing China's record in both poverty reduction and income inequality in Section 3, Section 2 provides a perspective to view poverty and income inequality in a developing economy (as opposed to a developed economy), where economic structural transformations, as cross-sector labor transfers as conceptualized by Lewis are the paramount challenge. The section will also suggest two useful concepts: "structural poverty" and "structural inequality". Section 4 then uses these concepts to provide an interpretation of China's strategies both to reduce poverty and to contain income inequality, one in the shorter term and the other in the longer term.

2. Structural Inequality and Poverty

It is widely recognized that poverty, inequality and growth are closely intertwined and form a complex set of triangular relationships. Among the most important is the recognition that growth can contribute to poverty reduction but only if the benefits of the growth can reach everyone in society, in some "equitable" manner. Specifically, in the case of absolute poverty, it means only if growth can help those living below some nationally or internationally specified poverty line of income escape from such poverty, and embark on some self-sustaining process of self-development and self-realization.

In the case of developing economies, this set of triangular relationship becomes even more complex, as growth also means a process of economic development, which, in the way Lewis had conceptualized it, entails a process of economic structural transformation, in particular a process of transferring labor from some less productivity sector of an economy such as agriculture to some higher productivity sector such as industry. That being so, what might apply to a developed economy, in the sense that its Lewis process has already completed, might not exactly apply to a developing economy which is just amidst its Lewis process.

What Lewis tried to capture in terms of the structural transformation Kuznets tried to capture in terms of income distribution. Both were dealing with the same process, that of transforming a poor, typically agriculture dominated rural economy to a richer, typically industry or service dominated urban economy. The frequently cited Kuznets

income inequality hypothesis was strictly meant only to apply to such developing economies, and not the developed ones.

In the context of a developing economy, as more and more of the workforce is transferred from the traditional, lower productivity and lower income sectors to some new, higher productivity and higher income sectors, then, other things being equal, income inequality can first worsen and then improve. A simple thought experiment may help clarify this point. Assume a simple economy consisting of two sectors, one a traditional low productivity and low income sector, and the other the new high productivity and high income sector. For simplicity, assume there to be no within-sector inequality, that is, everyone in each sector earns the same level of income from labor, and there are no other income sources. Initially, everyone is in the former sector. Then, before any cross-sector labor transfer, income distribution is completely egalitarian. Thereafter, upon the first laborer being transferred to the new sector, there begins to be some income inequality. And income inequality in this thought experiment will only become successively worse until about half of the labor force is transferred, whereupon it will improve as further labor transfer takes place.

What the Kuznets hypothesis was attempting to capture is this effect. Needless to say, any real economy is in no way an exact a copy of this hypothetical simple economy, in that labor need not be the only source of income, within-sector inequalities may be rife, and transfer incomes may already be present, so that any empirical analysis based on data containing influences of all these factors will find it difficult to isolate out the component of inequality that is due to the structural changes, as Lewis and Kuznets attempted to capture. For lack of a better term, this component of inequality associated with structural transformation of a developing economy may be termed as “structural inequality”.

Closely related to “structural inequality” is “structural poverty”, that is, when some section of the population remains unengaged by the structural change processes and their income falls or continues to stay below some nationally or internationally defined poverty line. However, whichever poverty line is used, this section of population is expected to fall in size as the Lewis-type structural transformation unfolds. Nevertheless, this trend need not be well-defined and clear-cut, as other factors inevitably intervene. Indeed, the trend may even be reversed, if income inequality over the process becomes so bad—for reasons unrelated to structural change—that some section of the population is left indefinitely in poverty. However, if the development process is inclusive, one would expect the number of these people to fall under any given standard of poverty. Needless to say, this fall may be rapid or slow, depending on how inclusive the development process really is.¹

¹ Naturally, if the poverty line is changed or raised over time, the number of those living in absolute poverty will change for this reason. The national poverty line in China has been raised quite a few times, and under each new, higher poverty line the number of the poor increased. However, for any given poverty line, the number of the poor has been consistently falling, as we will see in the next section.

Structural poverty is but one component of absolute poverty. The latter may also be caused by a variety of factors other than a lack of economic development or structural transformation of a country. Individual circumstances can exert a key impact. A lack of human capital stock may mean that even if employment and income opportunities are available to one, the person is not able to make full use of them. Without adequate health insurance, whether provided by the government or purchased individually, or both, a serious health condition may cause one to incur large sums of unplanned expenses, forcing one into poverty even if she was previously not. Other wider-impact events such as natural disasters, national macroeconomic events, and indeed global events such as the global financial crisis in 2008, can also have serious effects on the extent of poverty in a country.

So structural poverty is but one component of absolute poverty in a developing economy. However, given its nature, it is likely to be the most important and most extensive component. Over time, as cross-sector labor transfers take place, its importance will diminish, giving way to other components of poverty.

3. China's Economic Structural transformation, Poverty Reduction and Income Inequality

Rapid Economic Structural Transformation

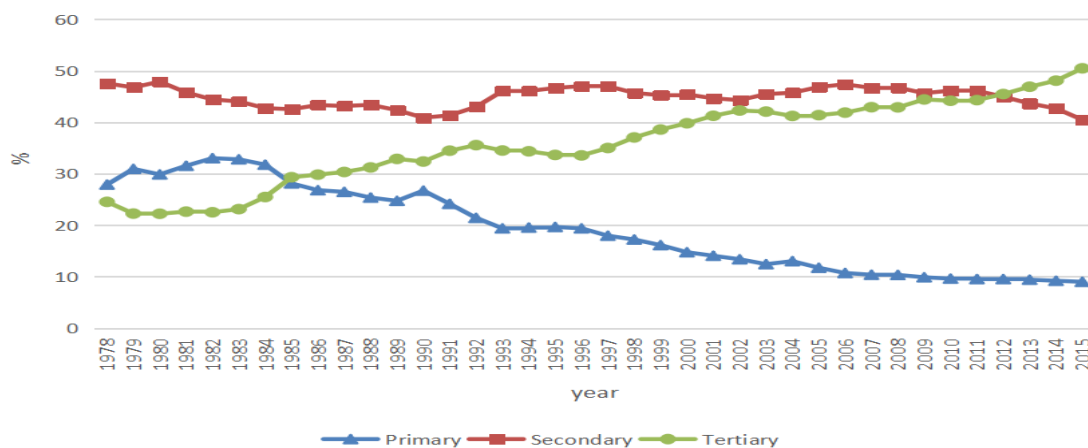
Although its growth rate has recently been falling, China underwent more than three decades of rapid growth, more rapid than in any of its past periods, and when compared with any other country over the same period. Figure 1 shows its annual gross domestic product (GDP) growth rates for the three decades 1978–2009 and the subsequent years, against the world's average growth rates. As can be seen, they lie consistently above the latter, in some years with a gap of over 10 percentage points. Except for the two years 1989–1990, generally this gap was between 5 and 10 percentage points in favor of the PRC. Over roughly the three decades of 1978–2009, China's average annual growth rate was 9.90%, while that of the world as a whole was only 2.98%. More recently, the two rates have moved closer together.

These high growth rates have both powered and been powered by rapid structural changes in the economy. Indeed, following a short period of rise in the early half of the 1980s, largely thanks to a rapid rise in agricultural output following the agricultural reforms in the country, the output share of the primary sector witnessed substantial falls, from around 30% in the mid-1980s to only 9% in 2015. The output share of the secondary sector consistently hovered above 40% but below 50% in most years. In 2015, it fell almost to 40%. Correspondingly, the share of the tertiary sector saw rapid increases, rising from only just above 20% in the early 1980s to a new high of 50% in 2015. Figure 2 presents the changing output shares of the three sectors over the period.

Figure 1: China's GDP Growth Rate since 1978



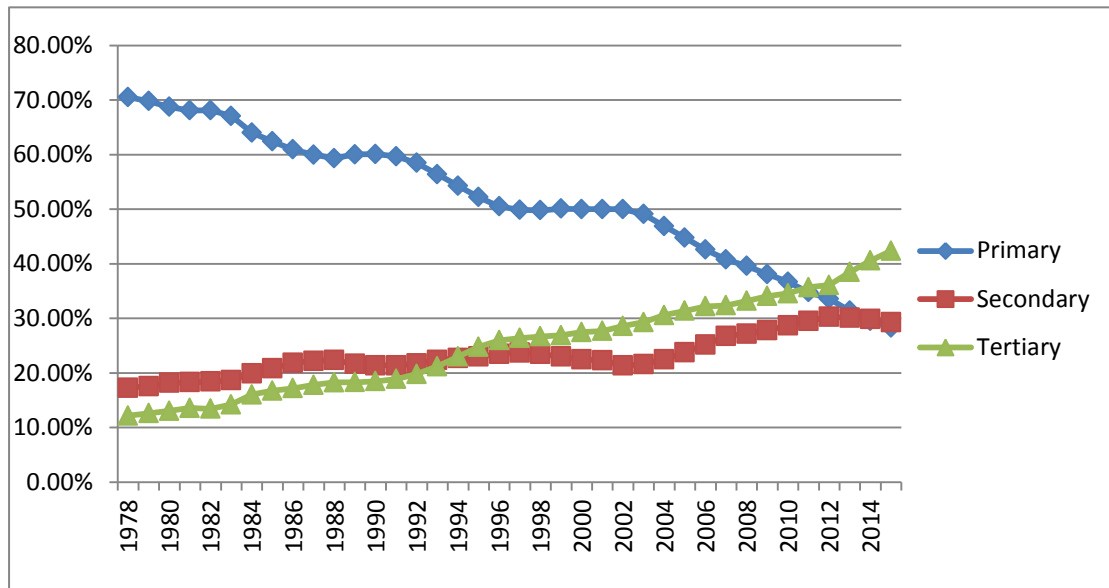
Figure 2: Output Shares of Primary, Secondary and Tertiary Sectors



Source: *China Statistical Yearbook*, various years.

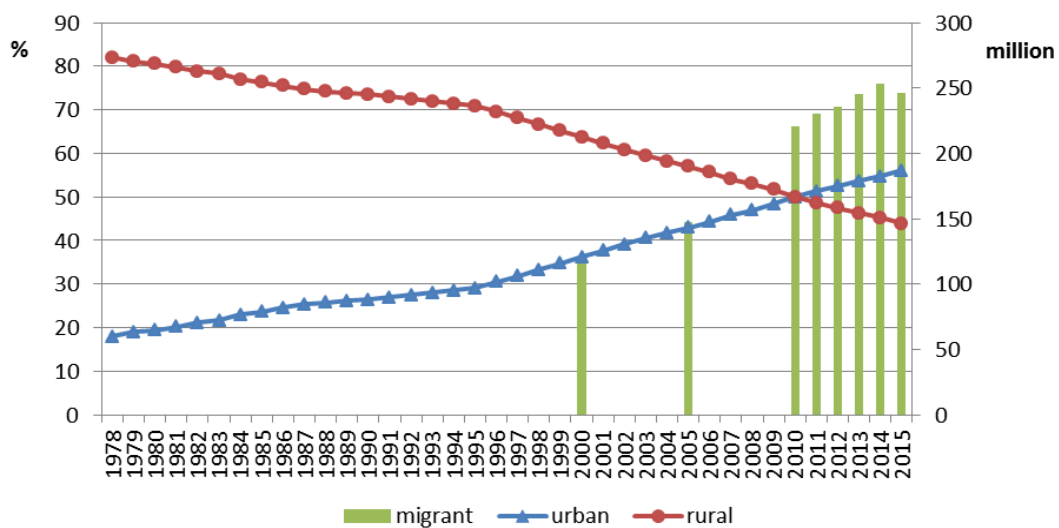
Employment shares of the same three sectors witnessed even more dramatic changes. That of the primary sector consistently fell from over 70% in 1978 to just over 28% in 2015. In contrast, the shares of the secondary and tertiary sectors both increased. The increase for the secondary sector has, however, been rather mild. It is the tertiary sector that has witnessed the most spectacular rise in the employment share, from just over 12% in 1978 to over 42% in 2015, a 30 percentage point jump over just three and a half decades.

Figure 3: Employment Share by Sector, China, 1978-2015



Source: China Statistical Yearbook, various years.

Figure 4: Changing Rural and Urban Population Shares



Source: CEInet Data.

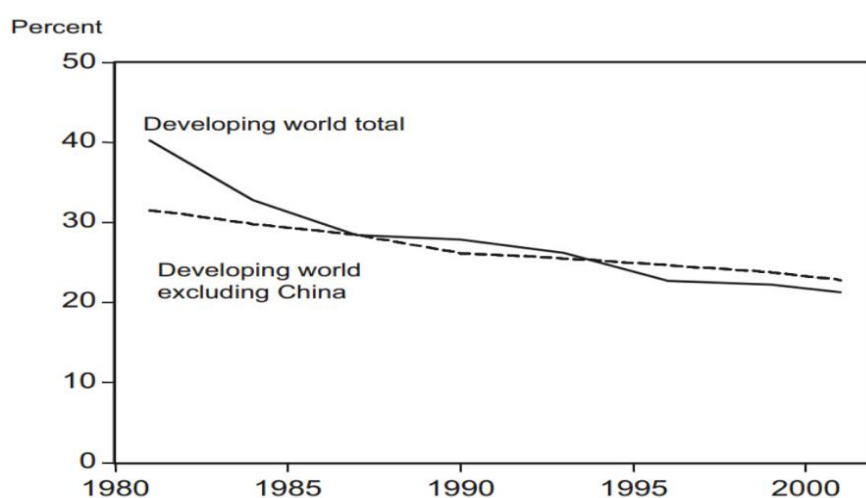
Much of this structural transformation was reflected as rural-urban migration. Over the same period, the urban sector rapidly expanded in terms of its population share at the expense of the rural sector. As a result of China's special dualistic features according to which a farmer may join the urban sector as a *worker* but not as an officially classified urban *resident*, a section of the population known as the migrant population also rose and expanded. According to available statistics, this section of the population totaled 121 million in 2000, increasing to 147 million in 2015 and 221

million in 2010. In 2015, the estimated number is 246 million. Figure 4 presents the changing shares of the rural and urban population in China. It would appear that they reached a par in 2010. However, if the migrant population were added to urban rather than rural population, that event would have occurred in around 2006, four years sooner.

Poverty Reduction

According to Chen and Ravallion (2004), at the World Bank one-dollar-a-day international poverty line (to be exact, 1.08 dollar a day in 1993 PPPs), the world's incidence of poverty was 40.4 % in 1981, falling to 21.1% in 2001. In China, that rate was 63.8% in 1981, falling much more sharply to 16.6% in 2001. In 1981, China's total number of the poor accounted for 43% of the world's total. In 2001, that share fell to only 20%. Over the 20 years, China had reduced the number of the poor by 108% of the total reduction in the world. China's record of poverty reductions in these two decades outperformed every other country in the world. Figure 5 highlights China's contribution to world's poverty reduction.

Figure 5: Poverty Reduction in China and the World, 1981-2001



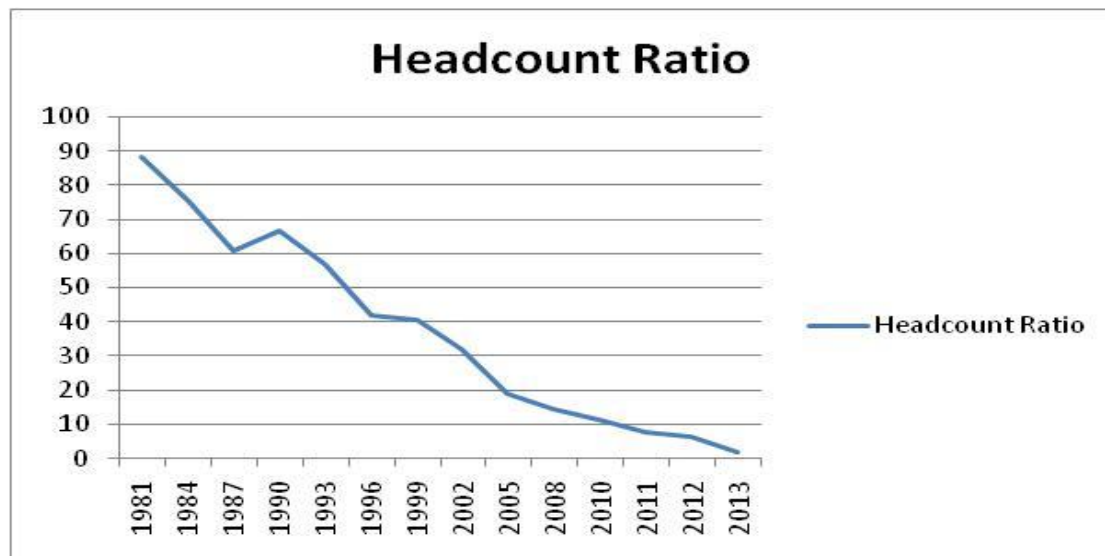
Note: The actual \$1 a day poverty line is \$1.08 (1993 PPP).
Source: Chen and Ravallion (2004).

Since Chen and Ravallion's above study, the World Bank international absolute poverty line has gone through two more rounds of adjustment, the most recent being at 1.90 dollar a day in 2011 PPPs.² At this new threshold, China's poverty reduction is even more dramatic. The number of the poor fell from 878 million in 1981 to 409 million in 2002, and 25 million in 2013, the most recent year for which World Bank estimates are available. In terms of the headcount poverty ratio, it stood

² The one-dollar-a-day international absolute poverty line was first set in 1985 PPPs (to be exact, 1.02 US\$ a day). Thereafter, this poverty line has been adjusted upwards a few times to be in line with evolving living costs in the countries, to 1.08 US\$ in 1993 PPPs, 1.25 US\$ a day in 2005 PPPs, and 1.90 US\$ a day in 2011 PPPs.

at 88.3% in 1981, falling to 32% in 2002, and 1.9% in 2013. Figure 6 details the reductions.

Figure 6: China's Poverty Reduction, 1981-2013, International Poverty Line (1.90 Dollar a Day)



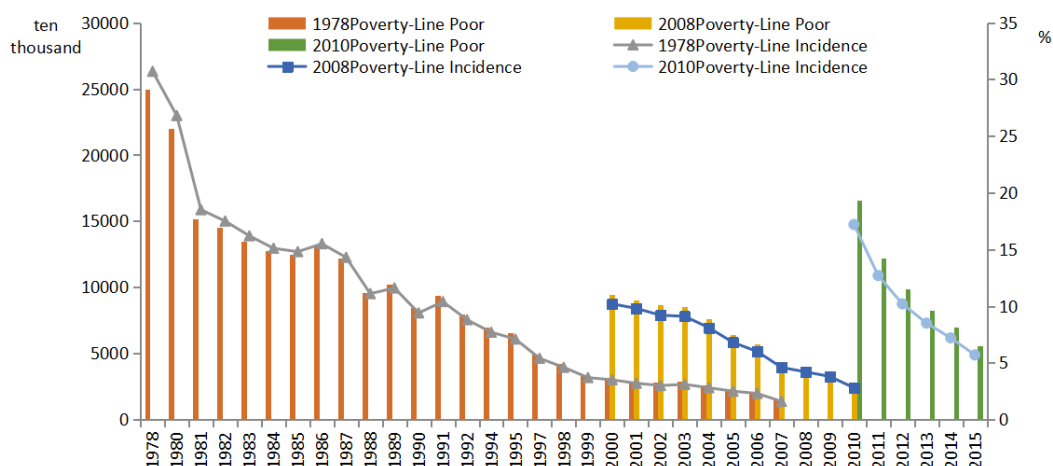
Source: World Bank

In part because of the various institutional features of China and in part because it is, in fact, an inseparable feature of a country that was still in its early phases of development, much of China's poverty had been and still is concentrated in its rural sector. That being so, most of China's success in poverty reduction also took place in this sector.³

China has had a succession of national standards of absolute poverty. Using these standards and covering much longer periods, China's State Council Leading Group Office of Poverty Alleviation and Development released its estimates of the reductions in the number of the rural poor. Figure 7 presents some of the key estimates. Using China's first national rural absolute poverty line of 100 RMB in 1978 prices, China's total number of the rural poor was 250 million people that year, accounting for 30.7% of the total rural population. The number then witnessed steady, and in some years very sharp, falls in the ensuing years. By 2007, the total number of the rural poor at that poverty line fell to 14.79 million, accounting for only 2.07% of the total rural population that year.

³ China has had a dual system of identifying and measuring absolute poverty, one for the rural poor and the other the urban poor. While the rural poverty line was determined very much in terms of the necessary cost of living to sustain a person biologically, and hence expenses on minimum food intake account for the greater part of the basket, the urban poverty line is determined in ways that are much less dominated by the cost of minimum food intake but also take into account expenses for meeting other minimum needs, for example, health and education. See Wang (2008).

Figure 7: Successive Rural Poverty Lines, Poverty Ratios and Numbers of the Poor



Source: http://www.cpad.gov.cn/art/2016/2/29/art_50_45702.html

With a general rise in the income levels across all sections of the population in the following decades, China’s national rural absolute poverty line underwent several upward adjustments. Naturally, each such adjustment meant an expansion of the scale of officially recognized rural poverty. Thus in 2007 when the government adopted a new poverty line of 1067 RMB in 2007 prices, the scale of rural poverty rose from 14.79 million to 43.2 million, accounting for 6.04% of the total rural population. Soon thereafter, in 2010, a still higher rural poverty line was adopted at 2300 RMB in 2010 prices. At this newer, even higher poverty line, the scale of rural poverty was again adjusted upwards, as is clear from Figure 7. At this newer poverty line, China had 57.75 million rural people living in poverty in 2015. At the official exchange rate, the newer 2300 RMB poverty line in 2010 prices is at a par to the World Bank’s extreme poverty line of one dollar a day. In PPP terms, however, it should be higher than the World Bank’s extreme poverty line.⁴

According to Ravallion and Chen (2007), China did not have much urban poverty. Using the same rural poverty line but adjusted for differences in prices,⁵ they estimated that China had only 1.62 million urban residents in poverty in 1981, an incidence rate of 0.82%. And by 2002, that poverty was all but wiped out. More recently, a new kind of urban poverty has emerged in China, related to the urban “migrant” population. From the perspectives discussed in the last section, we can view this as part of the Lewis process of labor transfer and urbanization. Depending on how this process further unfolds in the coming decades, this type of poverty may become part of urban poverty, or remain as a special category of poverty somewhat unique to China.

⁴ Very recently, China has upgraded its national poverty line again, to 2952 RMB in 2016 prices.

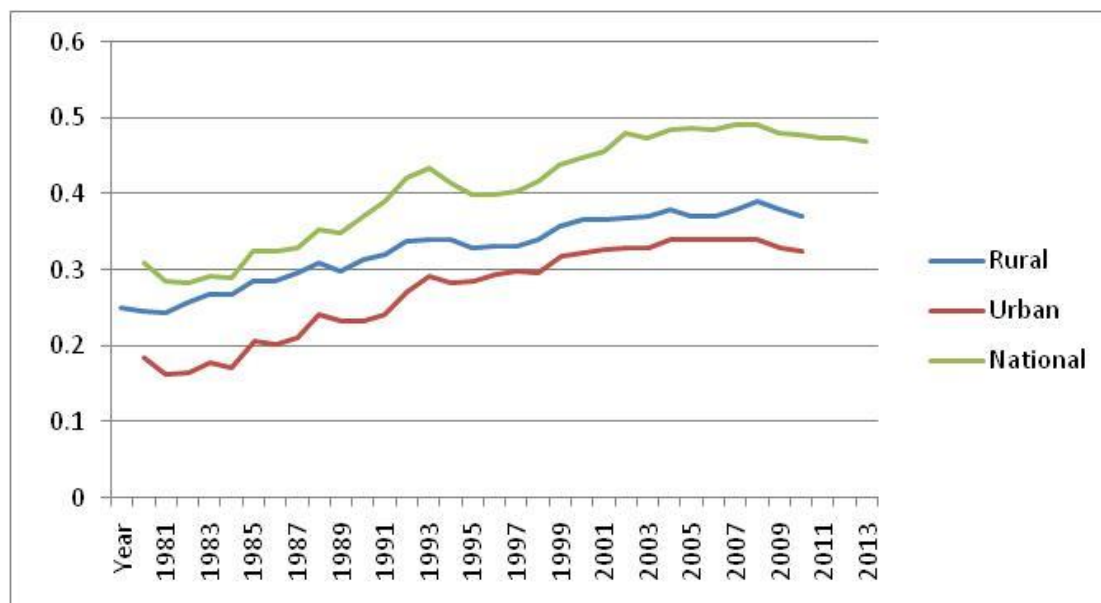
⁵ These adjustments meant an urban poverty line approximately 40% above the rural poverty line in monetary value.

Whichever poverty line one uses, there is no denial of the fact that absolute poverty went through consistent and quite sharp reductions in China in roughly the last four decades. As will be argued below, the dramatic falls in poverty in China in these decades were both a direct result of the development-led poverty reduction strategy that China had followed, and a by-product of general economic development and structural transformation in the country.

Inclusive Growth

The period of rapid economic growth and structural transformation has also been accompanied by a rapid worsening of income inequality. Figure 8 presents Gini estimates of these inequalities for the country as a whole, and within the rural and urban sectors separately. In all three cases, income inequalities became successively worse, not necessarily on a year-by-year basis, but generally so over roughly the three and half decades of 1980-2014. Worst income inequalities occurred especially towards the latter years of the 2000s. Thereafter, there appears to have been a reversal of these early trends. It is not clear if these new positive trends are signs that China has reached a point where structural inequality has begun to ebb, thereby causing the overall inequality indices to improve, but it would not be entirely unfounded to suggest that this might have happened.

Figure 8: Gini Coefficients of National, Rural and Urban Income Distribution, China, 1980-2014

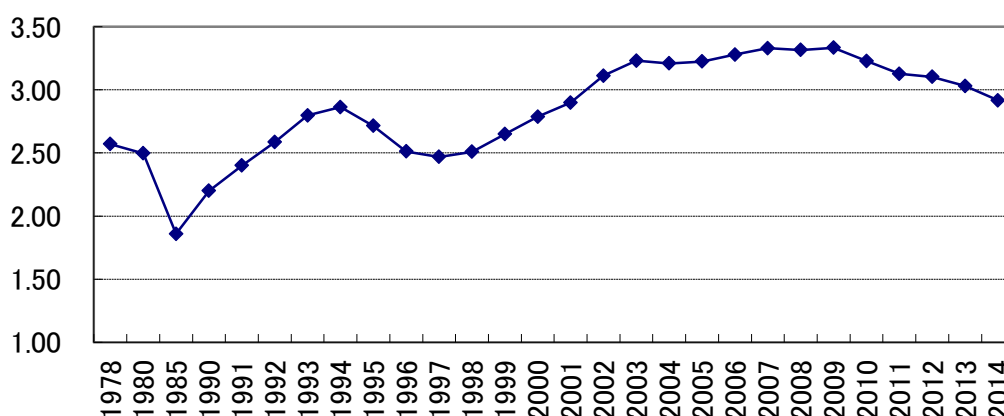


Source: Values for 1980-2001 are from Ravallion and Chen (2007), for 2004 from the World Bank databank, and for other years from Li and Sicular (2014).

This reading of the evidence appears to be supported by recent reductions in the income gap between the rural and urban sector. Figure 9 presents the changing size of this gap, as measured by the ratio of urban to rural per capita income. In 1978, the

ratio was just over 2.5. It then fell in the early 1980s to around 1.7, rising substantially thereafter to reach over 2.8 in 1994 (Li and Luo, 2007), then falling briefly again to below 2.5 in 1997. Thereafter, it rose consistently to over 3.3 in 2009. Since then, it has followed a clear, downward trend. The short-run fluctuations in this trajectory had to do with the particular immediate reform policies carried out by the Chinese government at various times, but the general upward trend until only very recently is unmistakable. It simply reflects the fact that China had been deeply amidst its structural change phase, the long and often arduous process of absorbing rural surplus labor into the more productive sectors of industries and services. Judging by the evidence presented above in Figures 2-4, it looks likely that for China as a whole, though not for every region therein, economic structural transformation has already reached what has been termed as the Lewis turning point in China.

Figure 9: Per Capita Urban-Rural Income Ratio, China



Source: Li and Luo (2011), Li and Sicular (2014).

4. China's Poverty Reduction and Inclusive Growth Strategy

Poverty Reduction

China's poverty reduction strategy has evolved in light of each phase of the economic development process it has reached. The most recent change to the strategy is to adopt accurate targeting, that is, to move the target of various poverty-reduction-specific government interventions away from poor "areas" and poor "communities" to poor "individuals/households". But before giving more details of this recent adjustment, it will be useful to briefly review the origins and preceding phases of the strategy.

A distinction needs to be made between a poverty-reduction-specific (PRS) strategy and a general poverty reduction (GPR) strategy. The former narrowly concerns all poverty-reduction-specific government interventions designed with the sole or

principal purpose to reduce poverty, and the latter a strategy that includes and embeds poverty reduction as a component objective, to be achieved through wider economic and social development, without taking action to directly intervene in poverty and its causes.

These two types of strategy differ in two more important respects. First, a PRS strategy clearly has to formulate a plan for targeting (e.g., whether to target a poor area, or community, or individual/household), while a GPR strategy does not involve such targeting. Secondly, while a GPR strategy is necessarily driven by development, a PRS strategy may or may not be so. It could, for example, take the form of providing social protections to the poor. On the other hand, it could also be “led” or driven through development. In the latter case, while targeting a poor area, community or individual, the strategy aims to assist the targeted party by improving its production and marketing conditions. This may involve such development oriented measures such as investing in local production, transport and communication infrastructures; providing trainings and skill transfers; or developing and expanding market outlets for local products and services.

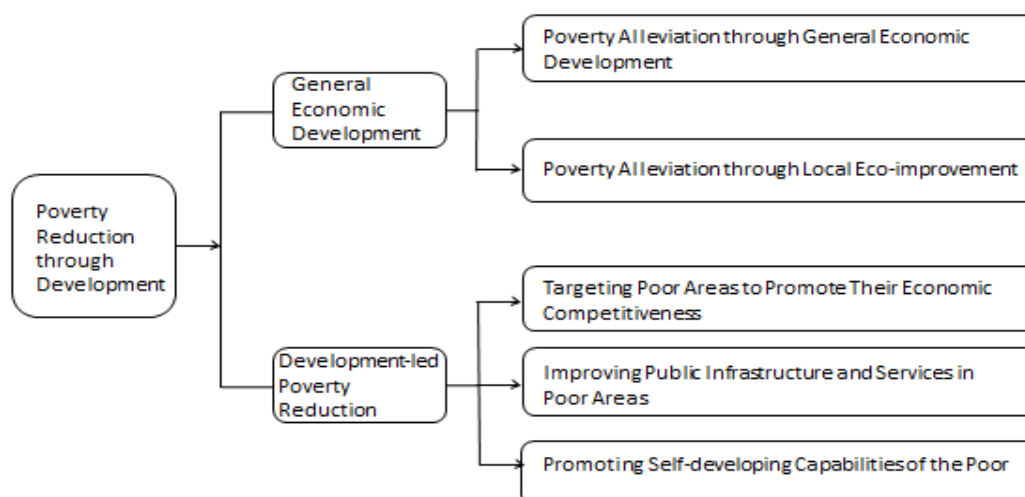
There is also a close interrelationship between the choice of target and the “mode” of intervention (i.e. whether through providing social protections or development oriented assistance, or both). For interventions through social protection, the natural unit of targeting would appear to be poor households and individuals, rather than poor areas and communities. However, for development-oriented interventions, the unit of targeting could be a poor area, a poor community, or indeed a poor household and individual. In the case of rural China, corresponding to these units of target are, respectively, a county, a village, or a farm household.

China’s poverty reduction strategy began with only a GPR component, but then evolved to consist of both a PRS and a GPR component. In the early 1980s, there were no government interventions aimed specifically to reduce poverty worth of mentioning. Nevertheless, China achieved sharp poverty reductions in the rural areas, largely through agricultural-sector reforms which involved both parceling farm land to farmers and increasing prices for agricultural produces. As well as passing on direct gains to farmers through the higher produce prices, these measures spurred farmers’ incentives for production. The achievement was, however, one-off only. Thereafter, China developed a PRS component and added to its overall strategy of poverty reduction. In particular, 1986 saw the establishment of the State Council Leading Group Office of Poverty Alleviation and Development, an umbrella office to liaise, strategize and coordinate different government ministries and offices to promote PRS interventions in the country, in particular in the central government-designated state-level poverty counties.⁶ Parallel programs also developed in each province targeting province-designated poor counties. Figure 10

⁶ When the Leading group was first formed in 1986, it was known as the State Council Leading Group for Economic Development in Poverty Stricken Areas”. It was changed to its current name in 1993.

provides a schematic outline of the principal components of the strategy, and their sub-components.

Figure 10: Components of the Poverty Reduction Strategy in China



Of the full strategy, the PRS component is known as “Development-led Poverty Reduction Strategy”. Under this strategy, PRS interventions were principally to take the form of development-oriented assistance using the range of interventions as listed above, and the principal unit of targeting or intervention was first the *county*. It remained that way until 2001 when it was decided to scale down the unit of intervention and to target designated poverty *villages* instead, while still using the full range of development-oriented interventions as before (but of course now within the geographical extent of each designated village rather county). More recently, since 2011, PRS interventions have emphasized “accurate targeting”, which further narrowed down the unit of intervention away from village to individual *household*. The balance of the range of interventions also shifted, no longer primarily development-oriented but now involving a much greater emphasis on social protections. This shift is understandable, as targeting individual households would mean a shift away from county- and village-based interventions which tend to be development oriented in nature.

There is clear economic logic to this history of evolution. Among the factors preventing the poor from escaping poverty, some can be broad in nature and can only be resolved by taking public or collective actions at a sufficiently large geographical scale. Examples of such factors include local transport and communication infrastructures, supply and marketing networks, human capital and skill developments, and various public utilities. In the context of China, an administrative unit suitable to be entrusted with the responsibility for planning,

mobilizing resources for, overseeing and managing the investment in these operations is that of county. Indeed, besides being sufficiently large in geographical scale, in the long history of China, counties have also been long established political and economic, and sometimes cultural, entities, often with a well-established local identity. So counties would also seem to be the natural units to undertake these tasks.

Besides factors which are best tackled at the county level, there are also factors which are best addressed at the village level. For example, building and managing a local irrigation system and farm road network, engaging in farmland consolidation, investing in and managing local schools and health clinics, and promoting local technical extensions, may best be organized, managed and undertaken at the village level. Like the county mentioned above, most of the times a village can be another long established political, economic and social entity.

Needless to say, there are also personal or household-specific factors preventing people from escaping poverty. Education and health status are obvious examples. Household dependence ratio is another, and so is one's economic and social standing within the village. These are best tackled at the household level through "accurate targeting". Moreover, having engaged in development-oriented interventions at the county and village level already, the remaining person- or household-specific factors may best be tackled precisely at the individual or household level.

In short, the evolution of China's PRS strategy represented a gradual narrowing of the unit of intervention and a gradual shift away from an overwhelming emphasis on development-oriented interventions to a more careful balance between these interventions and social protections provided at the individual and household level. There are good reasons for these transitions. A close correspondence between the interventions carried out at various stages and at various levels, and the changing circumstances of poverty in each phase in the country, is perhaps the very key to an adequate understanding of the reasons for the success of China's poverty reduction strategy.

Inclusive Growth

At one level, China's very successful record of poverty reduction is itself a testimony to the inclusive nature of economic growth, or development, in the country. However, our reflections need not be limited to this point. Over the last three and a half decades or so, while China's number of the poor has fallen sharply, its income distribution had consistently and significantly worsened for much of the period. However, in the most recent few years, that trend appears to have been reversed. As reported in Section 3, there appears to have been a clear narrowing of the urban-rural income gap since the end of the 2000s, and there are also signs that, measured by Gini coefficient values, national, within-rural and within-urban

inequalities have all appeared to have reached a plateau and are beginning to fall. It may well be the case that what we called “structural inequality” in Section 2 is beginning to fall, pulling the overall inequality level down for the country.

However, at this point in time, these are but conjectures. And even if these conjectures turn out to be true, China still faces a daunting task of reducing its income inequality to more acceptable levels. Of the many challenges, the following two are the principal ones.

First, increasingly, wealth has become an important source of personal income. Since the distribution of wealth has become highly skewed in the country, a rising importance of this source of income forebodes ill for China’s future income distribution. Might be the “dividend” of falling structural income inequality be offset or even overturned by the rising inequality from this source? Whatever the answer may be, clearly the government will need to act on this front, and act soon. Some kind and level of property tax would seem to be in order. Additionally, such a tax may also help to slow down the rise of property prices. However, there can be no guarantee of that happening. China’s property prices have been rising at an incredible pace since the turn of the century, fanned by an ill-designed local fiscal system whereby local government revenues depend heavily on public land sales. So it looks that in order to address the issue of property incomes and its impact on income distribution, one also has to take to task China’s fiscal system. However, without a clear and steadfast political resolve, this is unlikely to materialize.

Secondly, China will have to increase its levels of social protection to the poor and other low income groups. Needless to say, this should have an immediate positive effect on income inequality and other social inequalities. However, it can also have an important longer term effect. Depending on how such social protections are delivered, they may help the recipients to invest in their human capital, thereby raising their ability to earned higher income in the long run. And it this does not directly happen to themselves, then at least to their children. Note that the fact that such protections may have an impact on the human capital stock of a recipient’s children itself has an added benefit, that is, it can contribute to blocking the intergenerational transmission of poverty.

It needs to be recognized that there is a limit to the extent to which general economic development or specific development oriented interventions can help the poor or other low-income classes today to improve their circumstances. Much of their problem may not have to do with a lack of employment and income opportunities, but a lack of their ability to take advantage of these. In these cases, nothing short of adequate levels of social protection can help improve their living immediately and their human capital stock over time.

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