U.S.-China Economic and Security Review Commission
Staff Research Backgrounder

March 12, 2013

China's New Income Inequality Reform Plan and Implications for Rebalancing

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Income Inequality in China

China faces an already large and steadily growing gap in income between its urban and rural populations, and between its richest and poorest individuals. This inequality lies at the heart of much of the social unrest in China, and poses significant risks for the new Chinese Communist Party (CCP) leadership as it seeks to maintain a grip on power. The Party and the central government in Beijing have historically relied on strong economic growth to justify their authoritarian rule, but unless the benefits of economic reform are distributed beyond the urban elite, popular dissatisfaction with the Party and the government will grow.

Although government economic policies have delivered three decades of growth at an average 10 percent annual rate and lifted over 600 million people out of poverty,[1] the frequency of "mass incidents," the official euphemism for protests and riots, has increased from 8,700 incidents in 1993 to over 180,000 incidents in 2010, according to outside estimates.[2] Many such disputes involve allegations of official corruption and illegal land seizures by local authorities seeking to profit from the sale of land to real estate or manufacturing interests. In this way, ordinary Chinese can easily see evidence of government officials or their family and friends accumulating vast wealth at the expense of a politically powerless working class.

A new reform plan, released by the State Council in February 2013 after much delay, acknowledged these inequalities, noting that "the urban-rural gap and the difference in citizen's income is relatively large, income is irregularly distributed, there are obvious problems of grey income and illegal income, and some of the masses live in difficult conditions."[3] The program to reduce inequality had been in the works for eight years, spanning half-dozen drafts—all of them stymied by opposition from state-owned firms and other powerful actors that would lose out in any income-redistribution scheme.[4]

The 35-point blueprint, published on the central government's website under the prosaic title, "Income Distribution Plan," is aimed at boosting minimum wages to at least 40 percent of average salaries, loosening controls on lending and deposit rates, and increasing spending on education and affordable housing. Other reforms include a requirement that state-owned enterprises (SOEs) should contribute more of their profits to the effort of reducing inequality, and a commitment to push through market-oriented interest rate reforms to give savers a better return and more security.[5]

At least in theory, these measures signal an attempt to shift the economy away from the current reliance on investment spending and toward increased consumption as an underpinning for economic growth. However, China has no shortage of plans to accomplish this very kind of rebalancing, starting with the 11th Five-Year Plan and continuing most recently with the 12th Five-Year Plan.[i] All were put into effect only half-heartedly or got scuppered in the implementation phase, despite Hu Jintao's oft-stated

[i] China's 12th Five-Year Plan (2011-2015) is a government blueprint for the economy, which details a number of reform priorities aimed at restructuring the Chinese economy by encouraging domestic consumption, decreasing reliance on exports and investment, supporting the private sector, and shifting to higher value-added manufacturing. For more information, see "China's Five-Year Plan and Technology Development and Transfers to China" in U.S.-China Economic and Security Review Commission, *2011 Report to Congress* (Washington, DC: U.S. Government Printing Office, November 2011), pp. 88-106. *www.uscc.gov/Annual_Reports*.

goal of creating a "harmonious society."[ii] As is too often the case with many Chinese government pronouncements, poor implementation trumps lofty intentions.

This latest activity comes just after a long-awaited release of Gini coefficient[iii], which show inequality rising. China's National Bureau of Statistics stopped releasing annual Gini coefficient numbers in 2001, claiming that income data for wealthy households was incomplete.[6] In January 2013, officials finally released China's Gini coefficient index going back to 2003. The new data revealed that in 2012 the coefficient was 0.474, down from 0.477 in 2011 and from a peak of 0.491 in 2008.[7] Despite the slight improvement, Ma Jiantang, the head of the National Bureau of Statistics, said there was still a three-fold income gap between rural and urban areas, and a four-fold gap between workers in the most profitable industry and those in the least lucrative industry. That, said Ma, demonstrated "the urgency for our country to speed up reform of the income distribution system to narrow the poor-rich gap."[8]

While China's official income inequality puts it in the same category as the United States (the U.S. Gini coefficient was 0.48 in 2011, according to the U.S. Census Bureau), unofficial estimates of inequality in China paint a bleaker picture. Last year researchers at the Southwestern University of Finance and Economics in Sichuan province published a China Household Finance Survey, which estimated the Gini coefficient at 0.61 in 2010, putting China on par with the world's most unequal countries, such as South Africa and the Central African Republic.[9]

Income Inequality Reform Plan

Chinese household consumption has been declining as a share of gross domestic product (GDP) for decades, and came in at just 34.4 percent of GDP in 2011 (the latest available), an abnormally low rate and just half that of the United States.[10] Closing the income gap in China is especially important because low-income households spend a higher share of their income than rich households.

Despite its importance, the plan to reduce China's inequality has undergone several re-writes in the face of significant opposition from SOEs. According to researchers involved with the program, the final product was watered down to a general set of principles rather than a specific roadmap on how to redistribute wealth.[11] Indeed, although the final report lists 35 points for deepening the reform of the income distribution system, the only concrete recommendation pertains to increasing the dividends paid by the SOEs to the government.

In a policy statement filled with populist rhetoric, China's State Council pledged to boost the social safety net and then vowed to turn over more of the dividends from SOEs to pay for ambitious welfare programs and to take other steps to root out corruption and provide for the needy.[12] "Narrowing the income gap is essential for ensuring social justice and social harmony," said the State Council's statement. "We need to raise income levels of the poor and adjust taxes on the excessively wealthy."[13]

[ii] The "socialist harmonious society" doctrine, first proposed by the Chinese government under the Hu-Wen Administration during the 2005 National People's Congress, purported to promote a focus on an overall societal balance and harmony rather than economic growth. In practice, the "harmonious society" paradigm has come under criticism as corruption and income inequality actually worsened over the past decade. Pursuit of "harmonious society" is also often used by the government to justify the suppression of dissent and information controls in China (for example, "harmonized" has become a byword for "censored" in Chinese online jargon).

[iii] The Gini coefficient is a key measure of inequality. A coefficient of 1 indicates perfect inequality, while a coefficient of zero indicates perfect equality.

Some of the report's key points are discussed below.

Double Personal Income by 2020 and Raise Minimum Wage

The plan reiterated the goal, first announced last year, to double per capita income from 2010 to 2020. It also echoes some of the goals of the 12th Five-Year Plan. Many analysts have pointed out that at current growth rates incomes were set to double anyway.

The plan also calls for raising minimum wages in most areas to 40 percent of the local average wage level by 2015. Analysts were unimpressed because based on the official data, average earnings for migrant workers, the group most likely to benefit from hikes in the minimum wage, are already more than 50 percent of the average.[14]

Interest Rate Liberalization

The plan proposes interest rate liberalization, promising to "push forward market-oriented interest rate reform, appropriately expand the floating range for interest rates on deposits and loans and protect depositors' interests,"[15] which has the potential to boost interest payments to savers and therefore help raise household income. This reform is necessary for successful adjustment of China's economy to more consumption-driven growth. Interest rates on savings deposits have lagged inflation for many years, resulting in negative returns for households in a process known as "financial repression."[iv]

State-Owned Enterprise Dividend Payments

This is the plan's most specific step. It requires all SOEs to increase the amount of their earnings they remit back to the state budget by 5 percentage points by 2015. Although central SOEs are required to pay between 5 percent and 15 percent in dividends, depending on their profits and strategic value, their contributions to the treasury have remained low: In 2011, central SOEs earned more than 1 trillion RMB (around $160 billion) in net profits, but paid out only 82.3 billion RMB (around $13 billion) in dividends.[16]

A 5 percentage point increase in dividends paid by state-owned firms could add about 50 billion RMB ($8 billion) annually to the government's coffers and more as profits for the firms rise.[17] If that money is used for pensions and health insurance, it could help repair China's frayed social safety net and reduce Chinese households' precautionary savings.

Restrictions on Government Officials' Income

The new plan outlines a series of guidelines to limit excessive salaries for SOE executives. "For state-owned companies in some industries with overly high income, we will strictly implement the two-tier controls on firms' total salary and wage level to gradually reduce the salary gap between different industries," said the plan. The announcement also took on powerful state-backed monopolies, calling for "enhanced supervision" of large SOEs to avoid improper access to public resources at low or no cost. Oil companies and others have long resisted attempts to increase the amount they pay the state for natural resources.[18]

[iv] "Financial repression" is the implicit tax imposed on Chinese households, in the form of low and or negative real return on deposits, which suppresses their purchasing power and consumption. State-owned and state-influenced companies are the major beneficiary of financial repression, as they can borrow money at little to no cost. For more, see Nicholas Lardy, "Financial Repression in China" (Washington, DC: Peterson Institute for International Economics, Policy Brief PB08-8, September 2008).

The plan also promises to track and control illegal income, including from government officials: "We need to strictly enforce rules on accurate reporting of income, property and investment by all levels of officials," it said, adding that information on the employment of officials' spouses and children would all be watched more closely.[19] This is a very sensitive topic, as the discussion of the wealth amassed by powerful officials and their families is routinely suppressed. In 2012, New York Times and Bloomberg websites were blocked in China after they reported, respectively, on the wealth accumulated by the families of Wen Jiabao, China's then prime minister, and Xi Jinping, the new general secretary of the CCP.[20]

Tax Reforms

The plan introduces several tax reforms, including a consumption tax on luxury goods and high-end services, though perhaps the most important is the proposed expansion of the property tax pilot program currently limited to Shanghai and Chongqing. It is unclear if the new inequality plan will negate a previous announcement made in February 2013 in the China Securities Journal, a government publication. The expansion of the pilot program was postponed for a variety of reasons, including market immaturity, general complexity of the housing market, and the lack of clarity regarding property rights.[21]

China has been extremely slow in rolling out a nationwide property tax, which analysts say would be an important tool for spreading wealth more equitably. For several years, the government has pledged to levy property taxes but so far it has only targeted luxury properties in a few cities. The housing administration has said that it is moving slowly because of technical difficulties but many suspect that it is stumped by the question of how to deal with officials who have illicitly accumulated many properties.[22] In the latest in a series of scandals, state-run media alleged that an official in the public security bureau of Guangdong province owned at least 192 properties.

There is a one line mention of a proposal to "study" an inheritance tax to be introduced "at an appropriate time," which, along with consumption taxes on more high-end entertainment activities and luxury products, aims to increase the contribution from the wealthy.

Land Rights

Private land ownership remains *verboten* in China, despite years of discussion over possible land reform. By law, the government owns all the land and grants farmers rights to use the land. Though the farmers work the land, their legal claims to the land are tenuous. For example, the land cannot be sold or used as collateral for loans to invest in agricultural production.

The income inequality plan highlights the importance of protecting the rights of rural land owners and improving the land registration system, all considered important steps for boosting the incomes of rural citizens. Although the plan states that land requisition should be based on the principle of voluntary agreements, which would be in stark contrast to the practice of land seizures, it fails to specify any provisions for strengthening the farmer's legal rights to the land, or how any such "voluntary" contracts will be protected and enforced.

Disputes over land expropriated by local and provincial governments and corrupt officials have threatened political stability. Yu Jianrong, an expert on civil unrest at the Chinese Academy of Social Sciences, wrote in 2010 that disputes over land were behind 65 percent of social disturbances in China's countryside.[23] Outgoing Premier Wen Jiabao made the issue of farmers' rights a central point in his February 2012 visit to Guangdong, the site of the most famous of the recent clashes over land grabs from residents of Wukan village.[24] "What is the widespread problem now? It's the arbitrary seizure of farmers' fields, and the farmers have complaints about this, and it's even sparking mass incidents," Wen said. "The root of the problem is that the land is the property of the farmers, but this right has not been protected in the way it should be."[25]

Premier Wen was one of the government's more outspoken voices on protecting land rights, though his efforts appear to have been largely ineffective. The frequency of "mass incidents" over land grabs has continued to increase. A survey of 17 provinces, the sixth in a series, conducted by Landesa Rural Development Institute, in cooperation with China Renmin University and Michigan State University, revealed startling statistics:

Instances of "compulsory state acquisitions," or land seizures, have continued to increase in number since 2005, and over 43 percent of villages surveyed have experienced takings of land for non-agricultural purposes since the late 1990s. The survey also found that the mean compensation paid to affected farmers was 18,739 RMB per mu (approximately $17,850 per acre), a fraction of the mean price authorities themselves received for the land (778,000 RMB per mu or $740,000 per acre, mostly in cases of commercial projects).[26] The survey found that on average the government takes land from approximately 4 million rural people every year.[27] Nationwide, sales of land acquired from farmers generated 26 percent of local governments' revenue in 2011, according to China's Ministry of Finance data.[28]

Residence Permit System

The new plan makes mention of a standardized nationwide residence permit system, which could make it easier for farmers to move to the cities. A household registration system *hukou*[v] currently makes it difficult for people from the countryside to live permanently in the cities and have access to the same education and health benefits as urban residents. A reform in the *hukou* regime, if implemented, would go a long way towards reducing inequality between rural and urban residents, improve the living standards of China's migrant workers, and reduce savings and increase consumption levels—all of which are important for achieving overall rebalancing in China's economy. However, similar to land reform, *hukou* reform has been debated for years with no appreciable change in policy due to strong resistance by the local governments.

Social Safety Net

The plan calls for broadening of social safety net programs including increasing the participation of migrant workers in the pension system, improving the urban and rural pension systems and accelerating the establishment of a national universal healthcare system. The Chinese government committed to create comprehensive pension and healthcare systems by 2020, which should include benefits for rural and migrant workers. China has made significant first steps towards developing a social safety net in recent years, which could make an important contribution to cutting precautionary savings, but progress

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[v] Created in its current form in 1960, China's modern *hukou* system was first developed after 20 million migrants rushed to China's urban cities during the Great Leap Forward (1958-1960) in order to fill a perceived labor gap. Created to better control population migration, the hukou system requires the registration of all citizens in China at birth and then limits access to government services based on the residency permits issued after registration. Citizens' residency permits fall into one of two categories: urban or rural *hukou* and entitle a holder access to social services in the town or city to which their *hukou* is registered. For more on the *hukou* registration and its impact on migrant workers, see "China's Internal Dilemmas" in U.S.-China Economic and Security Review Commission, *2011 Report to Congress* (Washington, DC: U.S. Government Printing Office, November 2011), pp. 107-128. www.uscc.gov/Annual_Reports.

has been slow. For example, although 95 percent of the population is now covered by basic health insurance, benefits remain low and out-of-pocket expenses high (the rural healthcare system pays out $50 per person per year and reimburses 50 percent of the cost for in-patient care). [29]

The situation is similar when it comes to pensions. According to World Bank estimates, around 30 percent of China's labor force contributed to a pension scheme in 2008. The participation of migrant workers in the urban pension system doubled between 2005 and 2010, but remained at around 25 percent compared to 80 percent for local workers. [30]

Availability of financing remains a major obstacle. Based on IMF estimates, China spends only 5.7 percent of its GDP on health, pensions, and other forms of social protection, less than half the level in countries at similar levels of development.[31] Many economists have advocated that dividends paid by SOEs should be used towards expansion of the pension and health care systems, though it remains to be seen if and how any such reform is implemented (see earlier discussion on raising SOE dividends).[32]

Prospects for Implementation

Increasing the domestic consumption is a crucial component of reducing the massive divide between rich and poor. Similarly, a stronger social safety net is seen as crucial to China's economic rebalancing, freeing up household income for consumption. If implemented, these reforms might begin to address inequality and make a significant contribution to rebalancing the Chinese economy. But implementation remains crucial.

The history of Chinese reforms is littered with plans that never advance to implementation. The new income inequality plan is full of goals but light on specifics or timelines, and it remains unclear how they will result in concrete actions. The Chinese government has acknowledged that the "deepening reform of income distribution is a very huge and complicated project, and it can't be done in one step."[33]

For some, publication of the plan after such a long delay was a positive signal for reform. Eswar Prasad of Cornell University said that the plan "uses the goal of reducing inequality as an organizing principle for a comprehensive range of economic reforms. This is a strategically clever approach as it makes it harder for vested interests to block reforms."[34]

Other analysts were less optimistic. Yuan Guanming, a researcher with the Chinese Academy of Social Sciences, a government think-tank, said, "It's a good plan that came a little bit late," adding that he was "not very optimistic about the implementation."[35]

Wei Yao, China economist at Société Générale, acknowledged that the release of the plan shows that the Chinese government has recognized the severity of economic imbalances in the country, but noted that the plan itself was "too comprehensive to be implementable." He said that most of the points mentioned in the plan have already been suggested by either the 12th Five-Year Plan or by Hu's Party Congress speech and failed to offer much new information about how the government is doing to put these reforms into action.[36]

Li Gan, economics professor at Texas A&M University and Director of the Survey and Research Center for China Household Finance at Southwestern University of Finance and Economics, said the plan contained many good ideas but the shift in policy was not enough to make much of a difference. "China is only allocating 12 percent of its government spending to social welfare programs while the U.S. is spending 36 percent," he noted. "A two-percentage-point increase is not going to have substantial effect on income inequality."[37]

Signals from the Chinese government are similarly contradictory. On the one hand, the income redistribution plan was approved by the Ministry of Finance and the National Development and Reform Commission (China's premier economic planning and development agency), suggesting a buy-in from top officials, which bodes well for pushing through difficult reforms. On the other hand, the plan was released only after protracted battles within government circles about its contents. SOEs were some of the chief opponents, pushing back against calls for larger dividends. In the end, the 5 percentage point increase in their payouts to the public was in line with where they were already headed before the plan's announcement.[38]

The vague wording and absence of binding commitments in the new income inequality plan suggest the government may again shy away from challenging vested interests. For example, introducing a property tax risks exposing officials who have amassed vast real estate holdings, while giving farmers stronger land title would deprive local governments of one of their main sources of income (selling farms to commercial real estate developers).[39]

Corruption among government officials is a persistent problem in China, and a cause for popular discontent and social unrest. CCP General Secretary Xi Jinping has publicly taken a stand against corruption and government privilege. In several speeches since he took power, Xi has reiterated the comments of his predecessor Hu Jintao, that corruption could "kill the Party and ruin the country."[40] Some observers have pointed out that the elevation of Wang Qishan to the Politburo Standing Committee, China's top political leadership body, is a sign that the government may be getting serious about official corruption. Wang, whose background is in economic issues, was appointed at the head of the Central Commission for Discipline and Inspection, the Party's corruption watchdog agency, at the 18th National Party Congress in November 2012. Although it may seem like a mismatch in experience and portfolio assignment, Wang has a reputation as a capable problem solver, and could be a "firefighter" the Party needs to take on corrupt officials.[41]

Nonetheless, some analysts wonder how deep the reforms could be when government officials at all levels are involved in corruption.[42] The record so far does not inspire much optimism. In early 2013, a pilot project aimed at preventing and fighting corruption was launched in Guangzhou, the Guangdong provincial capital.[43] The project would require major Party and government officials to report their assets, investments and the employment situations of their spouses and children. However, even before the first results came in, local officials had declared their opposition to the idea of forcing them to disclose their assets. "Officials are civil servants, not slaves to the people," Ye Pengzhi, a member of the Guangdong People's Congress, told reporters. He said the government officials should be given "privacy" around their assets, "the same way that sick people get privacy for their medical records."[44]

Endnotes

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