

**CHINESE ECONOMIC REFORM
AND THE GROWTH OF INEQUALITY**

SEAN WHITTINGTON

POVERTY AND HUMAN CAPABILITY: SPRING 2008

Washington and Lee University

INTRODUCTION

Over a relatively short period of time, China has transformed its economic system from a centrally-planned state economy to a partially free market system. It was not until after the death of Mao Zedong, under the leadership of Deng Xiaoping that the economy began to open up in 1978. Over the past 25 years, China has been the most rapidly growing economy in the world. According to Susan Shirk, up until the mid-1990s, China experienced “reform without losers.”¹ Economic reform culminated in China joining the World Trade Organization (WTO) on December 11, 2001. Prominent economists argued that Chinese accession to the WTO would further economic development, raising the living standard of both Chinese and their trading partners.² One important ethical argument to consider in evaluating the merits of liberalized trade and economic reform is whether the benefits will accrue to the already wealthy or to the poor.³

One result of China’s economic reforms has been a net decrease in poverty as measured by the \$1/ day world bank standard. Still, 22% of the world’s poor, as measured by the World Bank’s \$1/day standard live in China.⁴ A disturbing trend resulting from economic reform has

¹ Susan Shirk, *CHINA: FRAGILE SUPERPOWER*, Oxford University Press 2007

² See *New York Times*, 2000 (“China’s entry into the WTO will raise living standards in both China and its trading partners. By acceding to the WTO, China will deepen its commitment to economic reform, and promote economic development and freedom.”).

³ Shaohua Chen & Martin Ravallion, *Welfare Impacts of China’s Accession to the WTO* 261. in Deepak Bhattesali, Shantong Li, Will Martin, eds, CHINA AND THE WTO: ACCESSION, POLICY REFORM, AND POVERTY REDUCTION STRATEGIES, The World Bank 2004 (“Some argue that external trade liberalization is beneficial to the poor in developing countries, while others argue that the benefits will be captured by the people who are not poor”).

⁴ See Jide Nzilibe, *The Case Against Reforming the WTO Enforcement Mechanism*, 2008 U. Ill. L. Rev. 319, 354 n 158 (noting distribution of worlds poor between India, China and Brazil).

also been a growth of income disparity.⁵ Income disparity produces marginalized members of society who do not have access to resources that would enable upward mobility and flourishing of their capabilities. Therefore, even in countries where few exist below global standards for poverty, poverty remains a systemic problem for members of society who exist at a level of wealth far below the socially acceptable standard as measured by that community.⁶ While China has experienced tremendous economic growth, it has also experienced rapidly growing income inequality. Inequality in China threatens not only those who fail to benefit from China's increased wealth, but also the political establishment which is sensitive to the dissatisfaction of Chinese people.⁷ This has led Chinese party officials to commission researchers to examine how to avoid the social unrest and economic stagnation that has occurred in Latin America because of the income gap.⁸

This paper examines the effects of Chinese economic reforms on poverty: first, by considering the net reduction of poverty as measure by the \$1/day measure; second, by analyzing the trend toward income disparity. Income disparity presents the problem of poverty in a different way than subsistence level measurement. Marginalized members of society are limited in their capabilities by their lack of access to resources that would enable them to function in

⁵ Terry Sicular & Yaohui Zhao, *Earnings and Labor Mobility in Rural China: Implications for China's Accession to the WTO*, in Deepak Bhattesali, Shantong Li, Will Martin, eds, CHINA AND THE WTO: ACCESSION, POLICY REFORM, AND POVERTY REDUCTION STRATEGIES, The World Bank 2004.

⁶ See John Cassidy, *Relatively Deprived: How Poor is Poor?* in *The New Yorker*, April 3, 2006 ("It appears that, while money matters to people, their relative ranking matters more.").

⁷ *China Daily*, March 8, 2004, ("The widening wealth gap caused as cities and coastal areas race ahead of the hinterland could spark social unrest and undermine the government's authority over the country's 1.3 billion people.").

⁸ Susan Shirk, *supra* note 1, at 31. ("The populism espoused by the Hu-Wen team-its special attention to improving income distribution and addressing the needs of the poor – is designed to avoid this fate [Latin American social unrest and economic malaise].").

society. China is uniquely responsive to income disparity and is attempting to find a way to move forward with trade liberalization and economic development that also addresses the problem of growing income disparity. This paper concludes by evaluating economic policy options to curb increasing inequality.

I. CHINESE ECONOMIC REFORMS

China began the 20th Century as a isolationist feudalistic society under the Qing Dynasty.⁹ In 1911, The Republic of China was formed and was held together under the Kuamintang(KMT). KMT was defeated by the Communists in a Civil war in 1949 and retreated to Taiwan. Mao instituted Stalinist state-run economic plans upon taking power and returned to the isolationism of the Qing era. The economic policies of Mao Zedong caused massive disruption of the Chinese economy.¹⁰

Starting in 1978, led by Deng Xiaoping and pragmatists within the Chinese Communist Party, China began economic reforms opening up to a more market-based economy.¹¹ Deng began with land reform; giving individual plots of land back to farmers and incentivizing production by allowing farmers to keep anything above the state quota.¹² This led to bumper

⁹ *Id.* at 19 (“The Qing Dynasty [] banned maritime trade with foreign countries until China was forced open by European imperialist powers.”).

¹⁰ *See id.* at 18 (“Mao’s lunatic campaign to surpass the West overnight by forcing peasants into huge collective farms, caused the largest famine of the twentieth century anywhere in the world”); *id.* at 13 (noting upon visiting China during the Maoist era in 1971 that “[m]ainlanders had Mao pins, Little Red Books of Mao’s quotations, and little else.”).

¹¹ Supachai Panitchpakdi, CHINA AND THE WTO: CHANGING CHINA, CHANGING WORLD TRADE 16, (John Wiley & Sons 2002).

¹² *Id.*

crops and a decline in the percentage of farmers in the workforce.¹³ Deng also opened up China to foreign investment. China learned from the foreign owned businesses that located there, and Chinese products increased in quality in order to compete in global markets.¹⁴ For 15 years, China waited as an applicant to the World Trade Organization (WTO).¹⁵ It joined in 2001 and opened up its domestic markets to foreign competition, dropping tariff rates from an average of 56% in 1982 to 11% in 2003.¹⁶ Since joining in 2001, China has drastically increased its share of world trade.¹⁷ Joining the WTO completed a trend away from isolationist economic policies to being a member of the global economy.

During the economic reform period, China has experienced unprecedented growth. The size of the economy quadrupled from 1982 to 2000.¹⁸ Living standards have also risen: over 10 million people own private cars and almost 400 million own cellular telephones.¹⁹ China has a sustained a per capita growth rate of 8% in the reform period. From 1978 to 2004, China sustained an annual growth in GDP of 10%. No country in history has maintained the level of per capita growth that China has in the past 25 years. Furthermore, China is capable of sustaining this high level of growth for two more decades.²⁰ China is on pace to quadruple the size of its

¹³ *Id.*

¹⁴ Shirk, *supra* note 1, at 19.

¹⁵ Deepak Bhattasali, Shantong Li, and Will Martin, *Impacts and Policy Implications of WTO Accession for China* 1 in Deepak Bhattasali, Shantong Li, Will Martin, eds, CHINA AND THE WTO: ACCESSION, POLICY REFORM, AND POVERTY REDUCTION STRATEGIES, The World Bank 2004.

¹⁶ Shirk, *supra* note 1, at 19 (“In just 25 years, China went from being a closed economy to one that is highly integrated with the international economy.”).

¹⁷ *Id.*

¹⁸ *Id.* at 19.

¹⁹ *Id.* at 17.

²⁰ *Id.* at 20.

economy again by 2020 at which point the per capita income will exceed \$3,000 placing it within the upper middle income countries by World Bank Standards.²¹

A. POVERTY MEASUREMENT AND INEQUALITY

Reformers consistently point to the huge reduction in people living at the \$1/day poverty standard as one of the greatest gains of economic reform. More than 400 million people have been lifted out of poverty as measured by the World Bank \$1/day standard.²² However, the recent *Quarterly Update* on China by the World Bank adjusted China's purchasing power parity (PPP) higher than was previously estimated.²³ This means that goods have been costing more than was previously thought and therefore the percentage of people living at or below the World Bank measurement for poverty of \$1/day will increase.²⁴ When taking into account the new PPP calculation, previous estimates of poverty as measured by the \$1/day standard will be adjusted higher. The *Update* states "[t]he \$1 per day poverty rate in 2004 is likely to be in the range of 13-17%, rather than the earlier estimate of 10%."²⁵

In a World Bank blog posting, David Dollar, the World Bank Country Director for China,

²¹ *Id.* at 21.

²² *Id.*

²³ World Bank Office, Beijing, *China Quarterly Update – February 2008* 21. (“[B]ecause prices are higher in China than previously thought, the new \$1 per day poverty line will be higher. The estimated number of \$1 per day poor in China will go up – but the estimated number in the past will go up as well. The choice of PPP conversion factor does not affect the trend.”).

²⁴ *Id.*

²⁵ *Id.*

spins the increased PPP as further evidence of poverty reduction in China.²⁶ Although the current poverty rate is higher than previously estimated, the PPP will also adjust the 1980 level of poverty higher, from 64% to 77%. The newly calculated reduction in \$1/day poverty from the 1980 to present levels will increase from 54% to 59%. Therefore, using the new PPP, the calculation of poverty reduction actually increases by 5%.²⁷ Still, Dollar notes the stark disparity between coastal cities and the inland poor:

It is natural to be struck by the glaring disparity between rural Gansu and coastal cities such as Shanghai, with their skyscrapers and neon. But when I travel I always like to ask people, in my mediocre Chinese, how their lives have changed in the past decade. It is hard to find anyone whose life is not far better than before.²⁸

Dollar's point is that while there may be a huge difference between the poor and the rich in China, one should focus on the gains made by reducing the numbers of those living in abject poverty.

Washington and Lee University

Globalization and integration in world markets has produced rapid decline in \$1/day poverty and an equally rapid increase in income inequality.²⁹ Pranab Bardhan notes that two decades ago China was one of the most economically equal countries and is now one of the most

²⁶ David Dollar, *New PPPs Reveal China had more Poverty Reduction than We Thought*, available at <http://eapblog.worldbank.org/content/new-ppps-reveal-china-has-had-more-poverty-reduction-than-we-thought>

²⁷ *Id.* (“The World Bank estimate of \$1 per day poverty in China at the beginning of reform will be raised to somewhere in the range of 71-77%. The old estimate was 64%. So, we used to think that 54% of China’s huge population had been lifted out of poverty during economic reform. The improved estimate will be around 59%.”).

²⁸ *Id.*

²⁹ See e.g., Pranab Bardhan, *Inequality in India and China: Is Globalization to Blame?*, Yale Global, October 15, 2007 (“The standard reaction in many circles to this phenomenon is that all this must be due to globalization, as Asian countries in general and China in particular have had major global integration during the last two decades.”).

unequal.³⁰ The GINI coefficient is used to measure inequality – zero representing no inequality and one being extreme inequality. In 1978, prior to economic reforms, China’s rural-urban GINI coefficient was an incredibly low .16.³¹ China’s current GINI coefficient is somewhere between .46 and .49.³² Anything above .45 is considered greatly unequal.³³ By comparison, the United States is more economically equal with a GINI coefficient of .41.³⁴

There is a clear tension between these two ways of measuring poverty. A recent article in the *Sydney Morning Herald* gives anecdotal evidence of the tension.³⁵ The article describes a 57 year-old factory worker in Beijing who has seen tremendous growth in her wages over her 20 year career. But, she said that her wage growth was “worthless” and changed for the worse because the food and furniture she can afford is extremely low quality and she is afraid of incurring the costs of a hospital visit. Furthermore, the money and stress have damaged her personal relationships. She considers herself very poor. This factory worker lives above the \$1/day World Bank measurement for poverty but still clearly considers herself deep in poverty because she lacks access to things like fresh meat, dependable furniture and health care. Even though her wages have increased, they have not kept pace with the rest of her community, leaving her marginalized.

³⁰ *Id.*

³¹ Jiang Shixue, *Emerging Income Inequalities in China*, Asian Development Bank Institute, September 29, 2003.

³² *Id.*

³³ *Id.* at 2 (“Judged by international standard, a country with Gini coefficient higher than 0.45 would be considered as being greatly unequal.”).

³⁴ Shirk, *supra* note 1, at 30.

³⁵ John Garnaut & Maya Li, *Inequality Soars Even as China’s Poverty Plunges*, *Sydney Morning Herald*, October 20, 2007. Available at <http://www.smh.com.au/news/world/inequality-soars-even-as-chinas-poverty-plunges/2007/10/19/1192301044792.html>

David Dollar suggests that everyone is a little better off and the number of people drawn out of \$1/day poverty is the most important figure. However, even though they might be better off, rural people live at a considerably lower standard of living than their urban counterparts. Furthermore, the anecdotal evidence in the Sydney Times article shows that disparity in income is having an effect on people in urban areas also. People whose wages are not keeping pace are relegated to a considerably lower standard of living.

B. TRADE IMBALANCE AND ECONOMIC POLICY

David Dollar defends the rising inequality in China as a necessary byproduct of development while proposing policies that may help stem inequality.³⁶ Dollar cites Sir Arthur Lewis that “development must be inegalitarian because it does not start in every part of the economy at the same time.” The coastal cities have benefited most from economic reform and WTO membership because they have access to global markets. The rural poor do not have access to global markets and China has adopted economic policies that make redistribution of wealth difficult. In China, free trade exacerbates inequality because the already wealthy are the one best situated to take advantage of the benefits.³⁷ Dollar argues that the best way to counterbalance the disequalizing effects of international trade is to redistribute income through domestic social spending.³⁸ China presently has a large trade surplus and the United States has a large trade deficit. Dollar notes that trade is an area that raises inequality issues for the United States as well

³⁶ See generally David Dollar, *Poverty, Inequality and Social Disparities During China's Economic Reform*, World Bank Policy Research Working Paper WPS4253

³⁷ *Id.* at 12 (“I also want to comment briefly on an important contemporary issue, the trade imbalance between China and the U.S., because ironically I think that the imbalance is exacerbating disparity in both countries.”).

³⁸ *Id.* at 13 (“A careful study of income distribution trends in all of the industrialized countries concluded that domestic policies were far more important than international trade in determining the final after-tax distribution of income.”)

as China.³⁹ Dollar argues that domestic policy in each country can address the problems that are created global competition rather than resorting to trade protectionism.

Chinese accession to the WTO has brought significant benefits to China.⁴⁰ China has set world records in export and import growth. As of 2004, China has “already reaped a ‘good harvest’ in its liberalization of trade, with its import and export shares in the world total rising from 1.0% and 0.9% in 1980 to 6.0% and 6.7% by 2004.”⁴¹ As of 2006, trade growth has increased by almost 30% since joining the WTO in 2001.⁴² But, trade exacerbates the disequalizing effects of economic reform in China. A 2005 World Bank study concluded:

The findings on the uneven nature of benefits between urban and rural areas are based on a survey of 84,000 Chinese households. Almost 90 percent of urban households reported income and consumption gains since WTO accession, while rural households, overall, experienced a modest average income loss of 0.7 percent. The poorest rural households however, suffered a sharp six-percent drop in their living standards, as measured by consumption, due to the combined effect of a drop in real wages and an increase in the prices of consumer goods.⁴³

Washington and Lee University

³⁹ In America, an open Chinese market creates opportunities for high-skill professionals while putting strain on manufacturing jobs and others with medium skills. This increase in wealth for those who can exploit opportunities in China is mainly limited to those who produce high skill goods like airplanes, owners of stock in Multinational Corporations, or those in technology sector. At the same time, manufacturing jobs are shifting to China where the labor is less expensive. This exacerbates U.S. inequality. Dollar points to universal health care and a more progressive tax system as possibly ways to reduce the disequalizing effects of globalization. The important point that Dollar would like to make is that domestic policies and not trade restrictions are better at equalizing income within a country. Social protections are necessary to protect low skilled workers from the effects of China’s entry into the World Trade.

⁴⁰ Angang Hu, *Tentative Evaluation of China’s Accession to WTO: Impact on World Trade Growth Patterns*, paper presentation at WORLD BANK CONFERENCE ON CHINA AND THE WTO, 24 September 2007, available at http://siteresources.worldbank.org/INTRANETTRADE/Resources/WBI-Training/288464-1152217173757/Hu_Angang_paper.pdf

⁴¹ *Id.* at 4.

⁴² Li Li, *China has a lot of lessons to offer other developing countries*, available at <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/EASTASIAPACIFICEXT/CHINAEXTN/0,,contentMDK:21153519~menuPK:318956~pagePK:2865066~piPK:2865079~theSitePK:318950,00.html>

⁴³ Christopher Neal, *China-Accession to WTO delivers\$40 Billion a year to China’s Economy but Gains unevenly Shared: World Bank Study*, 25 February 2005, available at <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/EASTASIAPACIFICEXT/CHINAEXTN/0,,contentMDK:20361323~menuPK:318970~pagePK:141137~piPK:141127~theSitePK:318950,00.html>

Those who are profiting from entry into world markets are those in urban port cities with access to global markets. Chinese economic policy is focused on exports and industry and therefore the coastal cities that can produce goods to sell overseas are encouraged by tax incentives and subsidies.

Most studies suggest that Chinese accession to member-status in the World Trade Organization is benefiting China and its trading partners. Different sectors are adjusting differently: apparel will greatly benefit because of the elimination of quotas; land intensive agriculture should increase; the automobile industry will need to adjust because tariffs will remain high; and the service sector should also experience growth. These adjustments will inevitably affect income distribution in China. It is anticipated that the rural-urban and coastal-inland income disparities, which are already at record levels, will be further exacerbated by entry into the WTO.⁴⁴ The dilemma that faces China is that entry into the WTO increases efficiency and integrates China more thoroughly into world markets but is also increasing inequality.⁴⁵

Hertel, Zhai, and Wang conducted a complex modeling of the likely effects of WTO accession as it related to each sector and location. They conclude that the greatest gains go to those who are already wealthy, namely specialized urban labor, and the smallest gains go to the poorest, namely rural farmers.⁴⁶ In fact, some of the poorest families could actually experience a loss because of accession based on the exit of labor from farming. This study confirms other studies

⁴⁴ Thomas Hertel, Fan Zhai & Zhi Wang, Implication of WTO Accession for Poverty in China, in Deepak Bhattesali, Shantong Li, Will Martin, eds, CHINA AND THE WTO: ACCESSION, POLICY REFORM, AND POVERTY REDUCTION STRATEGIES, The World Bank 2004.

⁴⁵ *Id.*

⁴⁶ *Id.* at 301.

that conclude WTO membership is likely widening income disparities.⁴⁷

China also encourages savings and foreign investment. James Fallows argues that China has promoted investment over domestic consumption and domestic investment, noting “[t]his is the real meaning of the vast trade surplus - \$1.4 trillion and counting, going up by about \$1 billion per day – that the Chinese government has mostly parked in U.S. Treasury notes.”⁴⁸ China has focused on savings and export-oriented growth at the expense of domestic services and infrastructure.⁴⁹ Fallows continues:

Much of China’s national income is “saved” almost invisibly and kept in the form of foreign assets. Until now, most Chinese have willingly put up with this, because the economy has been growing so fast that even a suppressed level of consumption makes most people richer year by year.⁵⁰

The result of export focused policies and focus on savings means that domestic infrastructure and social services; things like health care, education and the environment are neglected.⁵¹ Even though China is rich as a country, it lacks the things that are commonly associated with developed countries.⁵²

Also, because China depends so heavily on export growth, the renmibi (RMB) is intimately tied to the value of the dollar. Investing in domestic programs would mean reduced

⁴⁷ *Id.* (citing other studies).

⁴⁸ See James Fallows, *The \$1.4 Trillion Question*, The Atlantic January/February 2008, available at <http://www.theatlantic.com/doc/200801/fallows-chinese-dollars> (“China’s savings rate is a staggering 50 percent, which is probably unprecedented in any country in peacetime.”).

⁴⁹ *Id.* (“Through the quarter-century in which China has been opening to world trade, Chinese leaders have deliberately held down living standards for their own people and propped them up in the United States.”).

⁵⁰ *Id.*

⁵¹ *Id.* (“Better schools, more abundant parks, better health care, cleaner air and water, better sewers in the city – you name it, and if it isn’t in some way connected to the factory-export economy, China hasn’t got it, or not enough.”).

⁵² *Id.*

foreign investment. However, this option is frustrated by the fact that China fixes its currency using foreign investment.⁵³ Dollars that are received by Chinese entities are surrendered to the People's Bank of China at an exchange rate that is set by the government. Then China buys treasury bonds in order to stabilize its own currency.⁵⁴ Fallow summarizes the process: A dollar is "spent at CVS, passed to Oral-B, paid to the factory in southern China, traded for RMB at the Shenzhen bank, 'surrendered' to the PBOC [People's Bank of China] passed to SAFE [State Administration for Foreign Exchange] for investment and then bid at auction for Treasury notes, it is ready to be reinjected into the U.S. money supply and spent again – ideally on Chinese-made goods."⁵⁵ Most economists believe that this process causes the renmibi to be undervalued, thus helping exports. Also, China's accession to the WTO allows it to benefit from much lower tariffs on the goods it exports. This is a recipe for huge export growth; benefiting from a comparatively weak domestic currency and exports subjected to lower tariff rates. The percentage of Chinese GDP attributable to exports grew from 20% in 2001 to 36% in 2006.⁵⁶

The capital produced from the trade surplus is spent on investment in U.S. treasury bonds and not domestic infrastructure or social programs. However, if the RMB were allowed to appreciate the export sector, which has been the primary creator of new jobs, would be negatively affected. But, the export sector creates wealth for urban centers while making investment in rural areas and social spending more difficult. At the same time, the services sector has recently been producing more new jobs than manufacturing. Dollar suggests that

⁵³ Shirk, *supra* note 1, at 27

⁵⁴ *Id.* ("China, like other countries, buys American treasury bonds not to humble or to help the United States, but because it has to buy foreign exchange to keep the renminbi stable").

⁵⁵ Fallow, *supra* note 48.

⁵⁶ Reserve Bank of Australia, *The Composition of China's Growth*, available at http://www.rba.gov.au/PublicationsAndResearch/StatementsOnMonetaryPolicy/Nov2007/comp_china_growth.html

“exchange rate appreciation combined with some more social spending could help address China’s disparities.”⁵⁷ China’s economic policy is focused on growth via the export sector. This has locked China into policies which make it difficult to redistribute wealth to rural poor because the capital from the trade surplus is reinvested in foreign currency in order to keep the RMB stable which facilitates continued export led growth. But, the rural poor do not have access to the economically booming areas because China also restricts internal migration. The rich are getting richer, while the poor are getting poorer.

II. THE MORAL IMPLICATIONS OF WEALTH DISPARITY

Although China has made tremendous gains in reducing income poverty, income disparity has increased. The relatively recent accession to the World Trade Organization is likely exacerbating income inequality. China will be forced to develop policies that will address growing income disparity while at same time preserving economic gains made by opening up Chinese markets.

A. INCOME INEQUALITY AS POVERTY

In *Conceptualizing and Measuring Poverty*, Amartya Sen uses China as an example of how poverty should not be limited to income measurements.⁵⁸ Sen begins by noting the tremendous gains in poverty reduction as a result of China’s economic reforms. Sen states:

Although the exact estimates of the extent of the decline of poverty in China remain an important subject of debate as well as further empirical research, the fact of a sweeping poverty reduction is not under dispute. In fact, China is recognized to be the principal factor behind whatever downward trend that can be

⁵⁷ Dollar, *supra* note 36, at 20.

⁵⁸ Amartya Sen, *Conceptualizing and Measuring Poverty*, in *POVERTY AND INEQUALITY*, eds. David B. Grusky and Ravi Kanbur, (Stanford University Press 2006)

seen in the incidence of poverty in the world as a whole. Indeed, the trend of world poverty looks totally different depending on whether or not China is included in the world statistics.⁵⁹

Despite the gains in reducing poverty as measured by the World Bank standard, Sen notes that there is reason for concern because of the widening of income disparity as a result of the economic reforms. The growth of income inequality between urban and rural workers accounts for a sizable share of the recent world GINI coefficient rise from .628 in 1988 to .660 in 1993.⁶⁰ Sen concludes the “continued great achievements in income growth seem to have been accompanied, in the more recent years, with an intensification of inequality”.⁶¹

It still remains to be explained why inequality of income is a successful measuring tool of poverty. It is at least conceivable that an entire country’s population could live at an income which provides opportunity to flourish while at the same time maintaining an unequal distribution of wealth. First, the importance of income as a measuring device can be explained by the correlation to availability to basic necessities.⁶² It makes sense that a higher income level will enable individuals to acquire commodities like food, shelter and clothing that were unavailable before. But there is the further question of whether income “can really be the appropriate informational basis for assessing equity and social justice in general”?⁶³ Sen answers this by

⁵⁹ *Id.* at 30-31.

⁶⁰ *Id.* at 31.

⁶¹ *Id.* at 32.

⁶² *Id.* at 33. (“Inequality of incomes cannot but be relevant to evaluative assessment, because income is a general purpose means the shortage of which can reduce a person to serious deprivation.”).

⁶³ *Id.* at 34.

focusing on the capability of people to live a valuable life.⁶⁴

Income is merely a proxy for the type of lives that people are able to lead. The important point, however, is whether individuals are provided with opportunities or capability to function in meaningful ways within society.⁶⁵ Capabilities should not be limited to access to food and shelter, which income can approximate, but instead should account for social achievements like “being able to appear in public without shame and being able to take part in the life of the community.”⁶⁶ It is in this respect that income disparity becomes increasingly important. If a person lacks essential clothing, or goods necessary to interact in a community, she will essentially be locked out of that community.⁶⁷

Writing in the 18th Century, Adam Smith gives the example of appropriate clothing:

A linen shirt, for example is, strictly speaking, not a necessary of life. The Greeks and Romans lived, I suppose, very comfortably though they had no linen. But in the present times, through the greater part of Europe, a creditable day labourer would be ashamed to appear in public without a linen shirt, the want of which would be supposed to denote that disgraceful degree of poverty which, it is presumed, nobody can well fall into without extreme bad conduct. Custom, in same manner, had rendered leather shoes a necessary of life in England. The poorest creditable person of either sex would be ashamed to appear in public without them.⁶⁸

Therefore, one who is wealthy relative to the world standard may still be poor relative to their

⁶⁴ *Id.* (“It is precisely the distinction between incomes, on the one hand and well-being and freedom of persons, on the other, that drives a wedge between income information and the evaluative foundations of justice and equity.”).

⁶⁵ *Id.* at 34-35.

⁶⁶ *Id.* at 35.

⁶⁷ *Id.* at 36. (“A relative deprivation in terms of income can, thus lead to absolute deprivation in terms of capabilities”).

⁶⁸ Adam Smith, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS, Vol. 2, Book V, Ch. 2, Article IV (1776).

community standard because they lack the basic necessities to meaningfully interact with the community.⁶⁹ For example, in New York, one may need a television, a personal computer, a blackberry with consistently accessible email, and more in order to take a part in the community. This same set of commodities would not be necessary for someone in rural China or India.⁷⁰ In the same way, a person living in a suburb may be unable to maintain a job without a car because there is no public transportation. A well-respected tribal leader in Northern Thailand may lack an enclosed home, a television, a refrigerator or even shoes. This person will still be able to interact meaningfully with his community. A person lacking these commodities in America would be considered to be living in abject poverty. The capability of this person to interact and flourish in America would be completely deprived. It follows then that the eradication of poverty cannot be fully achieved merely by raising income levels. Instead, there must be some attempt to address levels of income inequality that lead to social exclusion. There is a meaningful distinction to be drawn between capability poverty and income poverty. Capability poverty is based on the relative deprivation to commodities which enable one to interact in a meaningful way.⁷¹

Contrary to being a novel idea, the economic intention to measure ‘quality of life’ standards’ has a long tradition in economics. An important motivator in the development of economic thought is the need to assess the opportunities people have for a meaningful life.⁷² Of

⁶⁹ Sen, *supra* note 58, at 36.

⁷⁰ *Id.* at 37.

⁷¹ *Id.* at 36 (“Although it is easy to see that income poverty and income inequality are distinct phenomena, nevertheless capability poverty relates inseparably to income inequality. An often articulated political attitude, which takes the form of saying, ‘I do care about poverty, but don’t give a damn about inequality,’ not only reflects a remarkably narrow approach to morality but also raises issues of inconsistency, given the causal linkages that make inequality and poverty so interdependent.”).

⁷² Amartya Sen, *DEVELOPMENT AS FREEDOM* 24-25 (New York, Random House 2000) (noting the tradition in economics of focus on quality of life through Aristotle, Adam Smith, William Petty, Gregory King, Francois Quesnay and Martha Nussbaum among others).

course, there is an intellectual tradition in America, that if basic necessities are provided, there is no further requirement to provide equality. Irving Kristol stated “[d]emocracy does not provide equality of conditions – it only guarantees equality of opportunity.” To this Sen responds that there is a clear causal linkage between inequality and poverty.⁷³ Capability poverty means that there isn’t equality of opportunity because some will be without the basic commodities that allow them to interact in society in a way that provides opportunity.

B. INEQUALITY IN CONTEXT: CHINA

This, of course, raises the question of whether the growing income inequality in China is truly capability deprivation. Sen notes that China began the communist period with an attempt to provide access to education and basic health. Feudalistic China, prior to the communist takeover, was characterized by extreme class inequality.⁷⁴ The progress made with respect to literacy, basic health and longevity pre-date the 1978 economic reforms.⁷⁵ When the communist party took over in 1949, China made great efforts to equalize capabilities and reduce capability poverty through investment in elementary functioning even though income poverty remained very high.⁷⁶ This is not to suggest that the communist model was working well. Sen notes that

⁷³ *Id.*

⁷⁴ Huo Jianying, *The Unequal Laws of Feudal Times*, in *China Today*, available at <http://www.chinatoday.com.cn/English/20024/time.htm> (“THE law of ancient China was characterized by a long history, continuity, and being geared to safeguard the interests of the ruling class.”)

⁷⁵ Sen, *supra* note 58, at 38. (“Through a visionary commitment to basic education, elementary health care, and social epidemiology, China made early achievements in levels of schooling, literacy, basic health, and longevity that far outshone those of many countries with much higher levels of GNP or real national income per head.”).

⁷⁶ *Id.* at 38. (“This early accomplishment of China related, from one perspective to the average of the country, but it also reflected a sharp decline in the traditional inequalities in education, health, and life expectancy as

income increase was necessary and would not have occurred without economic reform.⁷⁷ The economic reforms, however, also benefited from the large number of healthy educated adults capable of entering the workforce. The economic reforms were necessary and benefited greatly from the groundwork laid during the Maoist era.

Sen suggests that now there needs to be more extensive research on inequalities that lead to disparities and deprivations of basic capabilities in light of the incredible economic boom that China has enjoyed since the economic reforms.⁷⁸ Sen notes “the rise in income in the post-reform period has been so exceptionally fast that the slowness of progress in other areas has tended to receive comparatively little attention.”⁷⁹ Some evidence supports the view that equality that relates to capability is being compromised in the wake of the economic reforms.

For example, life expectancy and infant mortality rates are inferior to Kerala even though the 1979 measurements were similar. Sen suggests that these statistics relate to capability poverty and possibly capability inequality. Kerala has not had success in raising economic growth but has had great success in raising the length and quality of life of its citizens.⁸⁰ Kerala’s success is based on “support-led” process of coordinated social programs like health care and education.⁸¹ Furthermore, there are other high growth economies such as South Korea

well as a sharp decline in the traditional inequalities . . . as well as a sharp reduction in the deprivation of basic economic capabilities (and in this sense, capability poverty).”).

⁷⁷ *Id.*

⁷⁸ *Id.* at 39.

⁷⁹ *Id.*

⁸⁰ Amartya Sen, DEVELOPMENT AS FREEDOM 45, (Alfred A. Knopf: New York 1999).

⁸¹ *Id.*

and Taiwan that have had great success in raising the length and quality of life.⁸² Therefore, contrary to David Dollar's assertion, there is some evidence that development can occur without an increase in economic inequality. There is an argument, however, that China is *sui generis* based on its sheer magnitude. Kerala, though a model of success, has had to apply its social programs to only 30 million people. With 1.3 Billion citizens, there may not be a model that is directly applicable to China.

Also, the problem of shame that was identified by Adam Smith is present in China. Rural farmers are stigmatized within Chinese culture as lesser people than their rural counterparts. According to a BBC article, a common statement in Beijing is that "Rural people are of a very low quality."⁸³ Rural people are treated as second-class citizens and the social services and state infrastructure available to them are significantly inferior to the urban correlates.⁸⁴ Beginning in 1953, citizens have been classified as either urban or rural and rural citizens are denied the rights of urban citizens. This was put in place to restrict the migration toward cities, however, because of the opportunity many rural people move to the city and find themselves exploited and unable to gain access to things like housing and school for their children.⁸⁵

One point that is critical to this argument is to distinguish inequality that limits

⁸² *Id.*

⁸³ Rupert Wingfield-Hayes, *China's rural millions left behind*, BBC News Online, available at <http://news.bbc.co.uk/2/hi/asia-pacific/4782194.stm>

⁸⁴ *Id.* ("And rural people are not just treated like second class citizens, they are. Almost everything in the countryside is worse than in the cities, according to popular belief. People say the schools are bad, the teachers awful; there are very few doctors, and hardly any clinics or hospitals; local communist party officials are invariably corrupt, and often abuse their power for personal gain.").

⁸⁵ *Id.* ("The tens of millions who have moved to the cities find themselves treated like second class citizens there too. In a system akin to South Africa's apartheid, people born in rural China find it almost impossible to become full urban residents. They are denied access to urban housing and to urban schooling for their children. Work is found in factories or on construction sites. Life is a tenuous, hand-to-mouth existence.").

capabilities from inequality that merely creates envy. A lawyer doing public interest work may well earn a small fraction of a partner in a large Wall Street firm, but this does not lead to the inference that the inequality limits the capabilities of the public interest lawyer. Similarly, the mere existence of income inequality does not logically entail limited capabilities. However, the case in China is clearly capability inequality because it is based on access to basic necessities for functioning like health care and education. Rural workers do not have the same opportunities as their urban counterparts. For instance, China's state run newspaper, People's Daily notes that the "percentage of underweight children in China's metropolis like Beijing and Shanghai is close to zero while in the less developed western province of Qinghai the rate is almost six percent."⁸⁶

In a 2006 press conference, Ma Kai, China's top economic planner, addressed the new Five Year Plan (2006-2011). He stated that 45 million rural workers would be trained to take urban jobs by 2010.⁸⁷ He also stated that the government would provide 3.5 million new households with electricity and expand health care to 80% of the rural regions, as opposed to the 23% covered in 2006.⁸⁸ Furthermore, a compulsory nine years of education would be provided to rural children at no charge by the end of 2007. These policies are not aimed at alleviating envy but instead focus on providing basic opportunities to the impoverished. The prominence of equality-driven policies within the new Five-Year plan reveals how seriously Chinese Party leaders take the problem of inequality. These policies do not directly address income inequality *per se*, but instead focus on the capability inequality.

⁸⁶ *Disparity Widening in Asia*, People Daily, October 8, 2007, available at <http://english.people.com.cn/90001/90777/6278935.html>

⁸⁷ Fu Jing, *Five Year Plan Addresses Pressing Problems*, China Daily, March 7, 2006

⁸⁸ *Id.*

III. SOLVING INCOME INEQUALITY

A. THE IMPORTANCE OF SOLVING THE PROBLEM

The growth of income inequality that leads to capability deprivation is a political, moral and economic problem that the Chinese government has a strong interest in solving. The question facing Chinese leaders is how to solve such a complex problem while China is trying to integrate itself more fully into the global economy and benefit from record growth. Far from being simply a moral dilemma, income inequality is significant political problem for China.

Seventy percent of Chinese people believe that income inequality has “adversely affected social stability.”⁸⁹ Party leaders worry about the possibility of social unrest because of growing inequality.⁹⁰ Right now, the richest 10% control 45% of the China’s wealth.⁹¹ Also, urban incomes grow at twice the rate of rural income.⁹² National unity could be threatened by an increase in the disparities between rich coastal areas and the poor interior.⁹³ For a political establishment based on socialist principles, this sort of inequality seriously threatens the political establishment.⁹⁴ It is imperative, not only morally, but also politically, for China to develop inequality-fighting policies.

B. POLICY SOLUTIONS: MIGRATION AND INVESTMENT

⁸⁹ Shirk, *supra* note 1, at 31.

⁹⁰ *Id.* at 30.

⁹¹ *Id.*

⁹² *Id.*

⁹³ *Id.* at 31.

⁹⁴ James Fallow, The \$1.4 Trillion Question, (“China’s lopsided growth – ahead in exports, behind in schooling, the environment, and everything else – makes the country socially less stable as it grows richer.”).

David Dollar would argue that China should alleviate income disparity by domestic programs that target inequality.⁹⁵ He argues against protectionist trade laws that would serve to protect sectors vulnerable to global markets. The economist Zhiwu Chen argues that state involvement in the economy in the form of state-owned enterprises (SOE) increases inequality by concentrating wealth. Chen argues that as the state consolidated sole power in the Maoist era, inequality increased, however, when the state withdrew from the economy during the reform era, inequality decreased.⁹⁶ The macroeconomic policy of incentivizing exports is one way that China has contributed to inequality.

China can satisfy both by increasing spending on domestic social programs and infrastructure without increasing regulation or state-ownership of industries. China could reduce the amount of American treasury bonds purchased and instead invest in domestic public works. This would be roughly similar to American domestic policy during the depression where employing people for public infrastructure and social programs curbed unemployment.⁹⁷ Government funded investment in domestic projects creates wealth in the country by both creating jobs and improving infrastructure.

As noted above, China controls the exchange rate for the RMB which aids in export led

⁹⁵ See *infra*, notes 34-36.

⁹⁶ Helen Gao, *Chen: China should reduce state holdings*, Yale Daily News, April 13, 2008. (“Chen argued that instead of promoting economic equality, state ownership centralizes wealth and produces a wider gap between the rich and the poor.”).

⁹⁷ See e.g. Donald Howard, THE WPA AND FEDERAL RELIEF POLICY 105 (1943) (noting that the Work Progress Administration was “the administrative agency responsible for providing employment on socially useful projects for as many needy unemployed workers meeting prescribed eligibility requirements as can be given jobs with funds appropriated by Congress for this purpose from year to year.”). Whether or not Government employment actually created a net gain in employment is debatable. Some argue that employment was not actually improved until the War effort increased need for U.S. manufacturing. See Jim Powell, *Fresh Debate about FDR’s New Deal*, CATO Institute, available at http://www.cato.org/pub_display.php?pub_id=3327

growth. This is the current policy and move away from exports could allow China to subject the RMB to market forces. America has been lobbying for China to float the RMB. But, Chinese political leaders are wary of the possibility of losing exports or seeming to bend to foreign pressure to stop “manipulating currency.” On April 3, 2008 the China Currency Manipulation Act of 2008 (S. 2813) was introduced in the United States Senate.⁹⁸ The bill finds:

The People's Republic of China has engaged in protracted large-scale intervention in currency markets, thereby subsidizing Chinese-made products and erecting a formidable nontariff barrier to trade for United States exports to the People's Republic of China, in contravention of the spirit and intent of the General Agreement on Tariffs and Trade and the Articles of Agreement of the International Monetary Fund.⁹⁹

As a penalty, S. 2813 provides that the Treasury Secretary initiate consultations as the first method of dispute resolution provided for in the WTO.¹⁰⁰ Treasury Secretary Paulson opposes the bill but admits that China is not moving fast enough in floating the RMB and opening China's markets to American goods.¹⁰¹

This creates a political reason to float the RMB that will allow Chinese economic planners to operate without being bound by investing in foreign currency.¹⁰² Fallow notes that “[o]nce a government decides to thwart the market-driven exchange rate of its currency, it must control

⁹⁸ *China Currency Manipulation Act of 2008*, 110TH Congress, 2d Session, S. 2813. Available at <http://thomas.loc.gov/cgi-bin/query/D?c110:1:/temp/~c110dYzY9Z::>

⁹⁹ *Id.* at Sec. 2.

¹⁰⁰ General Agreement on Tariffs and Trade, Article XXII

¹⁰¹ Steven Weisman, *Paulson urges restraint in policy on China trade*, New York Times, Sept 11, 2007 (“Mr. Paulson said that there had been ‘many positive developments’ in relations with China, including recent steps to open up China’s markets to American banks and financial services. And Mr. Paulson noted that as of Monday, China had allowed its currency to appreciate 10 percent against the dollar since mid-2005.”).

¹⁰² Shirk, *supra* note 1, at 27 (“China’s central bankers would like to see China’s currency float because it would enable them to manage the macroeconomy without one hand tied behind their banks”).

countless other aspects of its financial system.”¹⁰³ This will admittedly cost some Chinese jobs, but as Susan Shirk points out, “China’s political leaders, fearful of losing exports, slowing growth, increasing unemployment, and risking unrest keep putting off the day of reckoning.”¹⁰⁴ Inevitably, China will have to allow the value of the RMB to be governed by market forces. If China accepts this reality and decided to invest in domestic programs instead of purchasing foreign currencies, they could target rural areas for investment that suffer from inequality. Right now the export-led growth policies obligate China to manipulate their currency by buying U.S. Treasury notes. By changing the growth policies to those favoring domestic consumption and social spending China will be free to allow the RMB to appreciate.

In *Rebalancing China’s Economy-Modeling a Policy Package*¹⁰⁵, Jianwu He and Louis Kuijs offer research on policy initiatives that will achieve several goals, one of which is reducing income inequality. Traditionally, China has favored industry and investment over services and domestic consumption.¹⁰⁶ One downside of this approach is that it “has created fewer urban jobs than a more labor intensive pattern, and has in the process increased urban-rural inequality.”¹⁰⁷ Rebalancing toward a more ‘harmonious’ society is a stated goal of the Chinese Communist Party.¹⁰⁸ The authors point out that China “would like to move to growth that is less intensive in

¹⁰³ Fallow, *supra* note 48.

¹⁰⁴ *Id.*

¹⁰⁵ Jianwu He & Louis Kunji, *Rebalancing China’s Economy – Modeling a Policy Package*, World Bank China Research Paper No. 7, September 2007, available at http://www.worldbank.org.cn/english/content/working_paper7.pdf

¹⁰⁶ *Id.* at 7.

¹⁰⁷ *Id.* at 10.

¹⁰⁸ *Id.* at 15.

resources and capital, cleaner, more knowledge-driven, and more equally distributed.”¹⁰⁹

The authors propose that China should move away from savings and exports, and increase focus on consumption and the service sector.¹¹⁰ They also maintain that their proposed policy will maintain overall economic growth while addressing social concerns.¹¹¹ He and Kunji identify several sets of policies that will facilitate a move toward China’s goals of reducing inequality while maintaining growth: first, policies which would stimulate the service sector, reduce domestic savings and stimulate consumption; second, changing tax and pricing policy to make providing services more attractive; and third, relax restrictions on rural-urban migration and provide cities with incentives to provide social services to migrants.¹¹²

Within the first set of policies, China should shift spending from investment to health, education and social safety; raise education spending to 4% GDP; ensure nine years of compulsory education in rural areas; ensure access to primary health care for everyone; and, speed up the opening and liberalization of financial markets to improve efficiency.¹¹³ This is not income redistribution, but instead, redistributes wealth in order to equalize capabilities by providing everyone with access to things like health care and education. Within the second set of policies, China should allow the RMB to appreciate according to market pressures; adjust the price of environmental inputs into manufacturing to bring them in line with relative scarcity and social preference; remove subsidies that offer a distorting incentive toward industry; and,

¹⁰⁹ *Id.*

¹¹⁰ *Id.* at 15.

¹¹¹ *Id.* at 1. (“The rebalanced scenario looks significantly better on the dimensions currently of concern to the government, while achieving broadly comparable overall growth.”).

¹¹² *See id.* 15-17.

¹¹³ *Id.* at 16.

implement WTO agreements in service sector.¹¹⁴ Within the third set of policies, China should relax the hukou, residency permit system which restricts movement from poor rural areas to the city; instead, China should aid the migration as it is able to create jobs in the service sector which will result from growth in the economy that is not industry-led.¹¹⁵ Taken together these policies provide greater opportunity for everyone. Floating the RMB will increase the costs of exports which could slow growth in the export sector. However, this will be offset by an increase in consumption and service jobs within China. Relaxing migration laws will allow Chinese people to move to urban areas where the majority of these jobs will arise. This will lessen the number of rural people working in agriculture and therefore increase efficiency and wages.

He and Kuijs calculate the effect of adopting these policies as compared with the economy progressing based on past trends. The modeling that He and Kuijs use is the Computable General Equilibrium that was developed by China's Development Research Center.¹¹⁶ The modeling is predictive of what will likely happen if all the policies are implemented but should not be taken as definitive. As expected, the rebalanced scenario has more growth coming from services and less from industry.¹¹⁷ There is significant reallocation of labor from rural to urban centers, .5% better overall growth in efficiency, and much less need for investment and exports.¹¹⁸ Most importantly, in the rebalanced model employment grows with the working age population.¹¹⁹ This model sees excess rural labor from agriculture being able to

¹¹⁴ *Id.*

¹¹⁵ *Id.* at 17.

¹¹⁶ *Id.* at 2.

¹¹⁷ *Id.*

¹¹⁸ *Id.* at 17-18.

¹¹⁹ *Id.*

move into the growing service sector.¹²⁰ Accordingly, “[t]his means that, even though saving and investment are significantly lower in this scenario, GDP growth is broadly the same as in the on past trends scenario.”¹²¹

In the on past trends scenario, the urban-rural income ratio gradually rises, from 3.8 in 1993 to 5.1 by 2035. On the other hand, the rebalanced scenario sees the urban-rural income ratio gradually decline to 3.0 in 2035.¹²² The GINI coefficient rises according to the “past trends” scenario, while the rebalanced scenario sees the GINI coefficient gradually lowering to .40.¹²³ This can be explained by “more urban employment and, as a result, more rural-urban migration, higher rural productivity and incomes, and less urban-rural inequality.”¹²⁴ Urbanization would rise to 72%, resulting in a stimulation to the service sector. Agriculture employment would fall to 12% but higher productivity will increase incomes.¹²⁵ All factors combined would basically sustain economic growth, albeit in different sectors, while at the same time reducing income inequality. Again, it should be noted that these are merely estimates based on modeling what would happen if all the policies were implemented. Even if the numbers are not absolutely correct, they reveal the trend toward equality that would result from adopting these policies.

He and Kuijs close with the most aggressive model to combat environmental harms and

¹²⁰ *See id.* at 19, Figure 8.

¹²¹ *Id.*

¹²² *See Id.* at Table 4.

¹²³ *Id.* at 20, Figure 8 (con’t)

¹²⁴ *Id.* at 20.

¹²⁵ *Id.*

income inequality. In addition to rebalancing policies, the corporate tax is raised by 30% and redistributed to low-income families in rural areas and outdated factories are closed.¹²⁶ This model leads to a lower GDP growth by an average of .4 percentage points. However, “[u]rban-rural income disparity will decrease to 2.4 in 2035, compared to 3 in the central rebalancing scenario.”¹²⁷ In this model, overall economic growth is not as aggressive, but the move toward equality between rural and urban areas is hastened.

In sum, if China implements policies that shift growth to the service sector and away from investment, overall growth will be roughly similar. The benefits of this approach are that income inequality will be reduced by more urbanization and job growth that can absorb a rural-urban migration. Those that remain in agriculture in rural areas will benefit by increased productivity and higher returns on their work. This all hinges on China allowing the RMB to be determined by market forces which will result in inflation but also allow economic planners in China more freedom in crafting macroeconomic policy.

CONCLUSION

In the course of the past 30 years, China has seen amazing gains as a result of economic liberalization. The economy has been led by industry and export growth that benefited from the 2001 entry into the World Trade Organization. However, while growth has been tremendous, it has been matched by a tremendous growth in income inequality. Income inequality may lead to capability deprivation where people lack the access to commodities that would enable them to participate in society.

With the most recent Five-Year Plan, China has set a goal of reducing inequality though

¹²⁶ *Id.*

¹²⁷ *Id.*

health care and education for rural areas and allowing more rural worker to migrate to urban areas. In order to do this, it is likely that China will allow the RMB to appreciate and be determined by market forces. This will allow them to invest their trade surplus in domestic infrastructure and social spending instead of buying U.S. Treasury notes. The export-sector will suffer from this move because exports will become more costly. However, overall economic growth can continue with domestic consumption and service sector employment. Taken together, these policies will increase the wages of rural workers, provide more employment to urban workers, facilitate rural-urban migration and maintain overall economic growth.

Washington and Lee University