An Evaluation of China's Experience in Poverty Reduction in the Light of the Successful Methods Elsewhere

A Summary of the Presentations at the Poverty Reduction and Development Forum and the Training Seminar for the Officials in the Poor Areas, Beijing 16-17 October 2010

Aziz Khan

Elements of the Best-Practice Poverty Reduction Strategy

The basic elements of the most successful poverty reduction path can be summarized as follows:

1. Rapid economic growth which is adequately employment intensive. Labor being often the only, and always the most important, resource with which the poor are endowed, this results in rapid growth in the earnings of the poor.
2. This can be greatly reinforced by improving the access of the poor to productive and productivity-enhancing assets like land, credit, skills, health and infrastructure. These measures enhance the productivity and remuneration of employment of the poor.
3. Since some, usually a small proportion, of the poor do not have adequate endowment of labor, there needs to be a supplementary public safety net, hopefully requiring no more than a small proportion of nations' resources.
4. The macroeconomic environment should: (a) ensure that the products of the poor and the products using the labor of the poor are not subjected to discrimination; (b) since success in poverty reduction is usually measured by the number and characteristics of those above a poverty line defined in terms of a minimum income/consumption, macroeconomic policies should ensure that a given growth in per capita income translates into a reasonably high rate of growth in personal

income. In other words, the elasticity of personal income with respect to GDP should not be suppressed to too low a level.

Once all the above elements are in place, growth becomes inequality averse or even equalizing. Some believe that poverty reduction and equality are separable objectives. If this is true, it is so only up to a point. If inequality rises steadily and significantly, the growth of the income of the poor must be slower than the overall income growth, thus hurting the cause of poverty reduction. Mathematically it is trivial to show that inequality measured by Gini or other indices can increase without a fall in the income share of the poor. But realistically such outcomes are quirks that are not found except over very short periods and that too with the poor constituting not a high proportion of the population. The attraction of the policy package outlined above is that there is nothing in it that reduces the incentive for and the efficiency of growth while it ensures that the resulting growth avoids increasing inequality. Examples of such cases in recent history can be found in the Republic of Korea, China's own Taiwan Province and several other East Asian countries.

Note that I am focusing on the narrow but widely-used concept of poverty, the people below a certain acceptable minimum level of income/consumption. If one were to broaden the definition to include reduction in shortfall of millennium development goals (MDGs) then a much wider range of policies will have to be in place. Most of the MDGs embody major externalities and some – status of women and an acceptable environment – are public goods for which the augmentation of private income is an incomplete, even ineffective, instrument. Broad public intervention is needed to make their achievement possible. It is ironical that the international development community adopted this broadening of development goals at a time when they also came to embrace the doctrine of limited government and overwhelming emphasis on the private sector as the vehicle for development.

Historical Roots of China's Deviation from the Strategy

When embarking on its current growth path by initiating reforms at the end of 1978, China faced obstacles that precluded the adoption of many of the elements of the path I have outlined above. The obstacles largely derived from the initial conditions from which

Chinese reforms began. We may recount that China started its reforms with an unusual slogan – "fight egalitarianism" – which apparently diametrically opposed the idea of inequality-averse growth. And yet the slogan had its logic. China's pre-reform economy adhered to a pervasive system of arbitrary egalitarianism which constituted a strong disincentive to productive efficiency. The undifferentiated wage structure; the universal, though strictly rationed, access to public services like education, health and housing; and the total ban on all private initiative including those that involved no violation of the Marxian taboo of expropriating "surplus value" - by the use of hired labor - had the same negative effect on incentives and efficiency.

As reforms began by scrapping these inefficient measures, forces of inequality were unleashed. These could have been offset by other measures which were not implemented for a variety of reasons. The most powerful offsetting factor to protect the income share of the poor could have been a high employment intensity of the rapid growth that reforms ushered in. As industrialization accelerated, especially since China's opening up to the global economy in the mid 1980s, employment in the new enterprises and industries did indeed expand rapidly. But this was offset by the need to retrench employment in state and collective enterprises in which an overwhelming proportion of China's workers were "employed". In the pre-reform period China used employment in these enterprises as means of social protection by expanding the number of workers on the payroll far beyond the level dictated by efficiency. The result was massive concealed unemployment in the state and collective enterprises which could not be sustained when these enterprises were opened up to competition from other forms of domestic enterprises and abroad. China's output elasticity of employment (OEE) in industries was pitifully low during the first two decades of reform. Incredibly, for about five years during the turn of the century – between 1997 and 2002 - aggregate industrial employment fell by 5% when industrial output increased by 55%. Only over the last five or six years has the OEE reached a decent level.

There were a variety of other possible offsetting measures which were largely voluntarily foregone. A significant source of increased inequality was the reform of taxes and subsidies including those in kind. It appears that the aggregate of the taxes and subsidies had a disequalizing effect on the distribution of income even before reforms. During the first two decades after the launching of reforms the subsidies that were removed were the more egalitarian ones and the subsidies that were retained were more disequalizing. Over time through the end of the last century net taxes became far more regressive: between rural and urban areas; within the rural and the urban societies; and for China as a whole.

One of the persistent sources of inequality in China is that between the rural and the urban economies, one that was prevalent in the pre-reform period. This has grown steadily during the reform period as public expenditure has been directed disproportionately towards the urban areas; the fiscal system has discriminated against the rural areas; and the control over population movement between rural and urban areas has widened the productivity gap between the rural and the urban economies. China's reforms started with the reform of the rural economy and a sharp improvement in agriculture's terms of trade. This was however quickly abandoned presumably because of its adverse effect on the rate of accumulation. By the late 1990s the change in agriculture's terms of trade as a policy instrument had become seriously constrained by the terms of China's accession to the WTO. Nor was the absence of improved terms of trade compensated by other measures. Agriculture's share of investment resources remained way below its share of population. Migration to urban areas was only grudgingly tolerated as the migrants were deprived of access to urban services and formal employment on equal terms with the urban residents. As a consequence, agriculture's share of GDP fell much faster than its share of employment, thereby widening the gap in labor productivity between rural and urban areas. Just to give an example, the ratio of the share of employment to the share of GDP for agriculture widened from 2.21 in 1990 to 3.04 in 2000 to 3.49 in 2009. In the successful East Asian cases cited above this statistic steadily fell during comparable stage of development, thereby reducing the productivity gap between rural and urban areas. A further persistent source of inequality in China has been that between regions: growth has been concentrated in the coastal regions which were the principal sources of exports during the period of globalization. They also received a disproportionately high share of infrastructural investment and incentives.

Finally macroeconomic policies were aimed at keeping the GDP elasticity of personal income/consumption very low. In the earlier years, i.e., until about the mid 1990s a justification for this could be the need to have a high rate of accumulation, savings and investment. By 1995 China had attained a more than 40% rate of investment. Thereafter there has been no trend increase in the rate of investment which actually fell for a period, though not for want of savings, and then rose again to the average of about 43% of GDP during the last half decade. Ever since 1990, with the solitary exception of 1993, China has been a net capital exporter in every year. By 2007 the rate of net capital export had reached a staggering 9% of GDP. These are extraordinary features for a country which is still avowedly developing.

China's Remarkable Success in Reducing Poverty despite the Deviation

Thus on almost every count of the catalogue of characteristics of the ideal strategy for poverty-alleviating growth, China appears to have defaulted. And yet China's success in poverty reduction has been remarkable. The World Bank has in recent years revised its internationally comparable poverty estimates by redefining the poverty line as PPP$1.25 per person per day at 2005 prices using the revised PPP$ income estimates. According to these estimates, between 1981 and 2005, poverty headcount in China fell by 627 million while it increased in the rest of the developing world taken together by 101 million. In 1981 China accounted for 44% of developing world's poor; by 2005 its share had fallen to 15%.

What accounts for this remarkable success? First, the sheer force of China's historically unprecedented uninterrupted growth during the last three decades has pulled up the vast majority of the poor above the poverty line. Secondly, China did several other things right. The most important among them is the universal equitable access to land for the rural population. In the vast sea of continuously rising inequality, the distribution of farm income has been an island of equality providing protection for most of the rural population from extreme poverty. Over time land distribution has become more equal and has ceased to be a source of income inequality. Thirdly, China has made a number of other policy responses, mostly in recent years, which have helped poverty reduction. These latter responses are briefly discussed later.

Could China Have Done Better?

Should one conclude that China's poverty reduction program has been without blemish? Could China have done better by way of reducing poverty? The answer is an emphatic yes.

But first, are we talking about a problem that is non-existent in China? Reports circulating in October 2010 suggest that for the current year the official estimate of the poor – those below 1300 RMB per year – is just 40 million of rural population. This is about 6 per cent of rural population. Officially poverty is not recognized to exist in urban China, a claim that many would contest. The World Bank's latest estimate of the number of people below 2005 PPP$1.25 is 211 million (15.9%) for 2005 counting the poor in both rural and urban China. I suppose for 2010 it would be less, though I do not know by how much. Translated into current RMB at PPP exchange rate the 2005 PPP$1.25 would probably be about 1,940 RMB per year or about 50% higher than the reported domestic poverty line for 2010. The total population below a poverty line of this magnitude may turn out to be between 150 and 175 million. This would be between 11% and 13% of the population. Without a doubt even the new (reported) higher domestic poverty line of 1300 RMB is far too low a threshold for China to measure its poor. Even the World Bank threshold is less than 10% of China's per capita GDP. To compare, for India it is 19% and for Indonesia 14%. While the internationally-comparable poverty threshold serves a useful purpose for the multilateral development agencies, there is no particular advantage for China to use the same standard to measure its own poor. The use of a more reasonable absolute poverty threshold would indicate the prevalence of a substantial proportion of its population in poverty. Clearly poverty remains a significant problem for China to continue to worry about.

Could China have done better than what is a spectacular performance by international standard and if so, how? I would argue that while China's initial dismantling of arbitrary egalitarianism was largely right, it went overboard by unleashing unnecessary increase in inequality for too long. China's inequality, measured by the Gini index, went up from about 0.3 in 1978 to 0.45 in 1995 where it stood in 2002. Many believe that, due to the failure of the surveys to capture extreme incomes, these estimates understate the increase in China's inequality. There are many compensatory actions that China could have adopted to arrest this trend. A less disequalizing growth would have resulted in a much lower incidence of poverty in China today.

As already noted, some increase in inequality over what it was at the beginning of reforms was inevitable and almost certainly desirable; but its increase to the levels reached at the end of the 1990s was neither desirable nor unavoidable. Indeed the disequalizing effects of dismantling most of the inefficient and arbitrary systems, institutions and policies of the past could have been offset by countervailing actions. A few such actions, notably the egalitarian access to land, were actually implemented with very good results. Other countervailing actions that would have mitigated the effects of disequalizing reforms include the following:

(a) Freeing of the wage structure from the shackles of Maoist egalitarianism could be combined with wider provision of skills especially to the disadvantaged;

(b) Laying off those in concealed unemployment in state enterprises could be offset by public works programs for capital construction in poor areas and the institution of a transparent system of unemployment insurance;

(c) Legalizing private and individual enterprise could be combined with programs for credit and other forms of support for small entrepreneurs;

(d) The increase in urban/rural inequality could be contained by continuing with the early policy of improved terms of trade and larger investment in agriculture; and a more rapid and transparent dismantling of the residence permit system;

(e) The shift of public investment in infrastructure development to western and central provinces could start much earlier and incentives could be devised to direct a greater flow of other forms of investment to those areas; and

(f) The regressivity of the extreme kind that characterized the system of taxes and subsidies could be replaced by a moderately progressive, at the very least a neutral, structure.

(g) Macroeconomic policies could have permitted a higher elasticity of personal income with respect to GDP.

Why did the Chinese policy makers not implement these countervailing actions and/or waited as long as they did before implementing some of them? It seems likely that they considered these actions and rejected them, with some exceptions over short durations, as inconsistent with their primary objective, namely the single-minded pursuit of growth led by a high rate of accumulation and the allocation of investment in activities and locations of high productivity. Each one of the countervailing measures could be interpreted as a potential source of reduction in accumulation. This justification however lost its force during the 1990s when China emerged as a net capital exporter, a point to which we return later.

It appears that China started making policy amendments in the wake of the Asian financial crisis in the late 1990s when it seemed that the dependence on exports as the primary source of growth needed to be supplemented by a faster rate of growth in domestic demand. Numerous actions were initiated to achieve this objective:

1. In February 2000 the State Council adopted the "Great Western Development Strategy" which initiated a new approach for the promotion of economic development in all the western provinces as well as the relatively poor provinces in the central region. The program has led to a large increase in investment in infrastructure development in this region. It is highly likely that improved public expenditure in these poor provinces has served as the impetus for reduced inter-provincial inequality. In October 2001 the government issued the "Outline for Poverty Alleviation and Development of China's Rural Areas (2001-2010)". This new plan emphasizes agriculture and farm production; the provision of education and training to the poor; the use of science and technology to promote the productivity of the poor; and the facilitation of out-migration and voluntary resettlement of people from ecologically disadvantaged areas. While the official system of residence registration has continued, there has been a great deal of de-facto liberalization of movement of labor out of rural areas.
2. Another element of the redirection of poverty reduction strategy in the late 1990s is the adoption of a program for the protection of the urban poor. Three instruments designed for this purpose are: (a) a living allowance for laid-off workers, which is the largest, though a transitional, program; (b) unemployment

insurance, which has been replacing the transitional living allowance for the laid-off workers; and (c) the Minimum Living Standard Scheme, which is a subsistence allowance paid out of the general revenue of the government. Increase in the share of these items in urban household income and the improved distribution of this source of income have been a factor behind the reduction in urban inequality between 1995 and 2002.

3. Significant improvements have also taken place in reducing the disequalizing effect of the system of subsidies. It seems that the completions of housing reform was a major factor in making subsidies both smaller and less disequalizing. Housing subsidies, concentrated in urban areas and benefiting the relatively high-income groups, were strongly disequalizing. The privatization of housing eliminated this disequalizing component of the fiscal system.
4. Finally, the cause of poverty reduction was helped by a faster growth in personal income, albeit highly skewed in favor of the urban areas. Policy makers in China were clearly concerned about their ability to maintain an increasing incremental share of growth in aggregate demand from external sources and this may have induced them to take measures to redistribute income in favor of the households in the hope of inducing them to increase their consumption. Growth in personal income, as a proportion of GDP growth, was far slower in the pre-Asian crisis period than in the post-crisis period. The policy seems to have paid off in so far as the precipitous decline in the ratio of final consumption to GDP and the ratio of household consumption to GDP between 1988 and 1995 was arrested over the period between 1995 and 2000.

Largely due to these measures there was a break in the rise in inequality around the turn of the century.

Looking Forward

There are indications that public policy in China may have initiated a change of course again in 2009 when, faced with the great world recession and its effects on demand for exports, it opted for the largest fiscal stimulus, in terms of the proportion of GDP, of all nations. While not enough is known about the composition of the stimulus, it appears that it will be skewed in favor of less developed regions and in employment-intensive infrastructure and reconstruction projects increasing the prospect for rapid growth in domestic consumption. These resources should facilitate the implementation of the countervailing measures that I have listed in the preceding section. There are however some serious obstacles to desirable reforms.

There are two sets of problems that appear particularly complex and are likely to tax the limits of the imagination and ingenuity of the policy makers. The first is the reduction in the rural/urban inequality. Since most of the poor are in the rural areas, a reduction in this gap is an essential key to the reduction of poverty. It is unlikely that options like a favorable, policy-induced shift in agriculture's terms of trade would be consistent with China's WTO commitments. An improvement in agriculture's *single-factoral terms of trade*, large-scale investment to boost agricultural productivity, is a desirable alternative and should be pursued. But this presupposes that China has the necessary comparative advantage in agriculture which is doubtful. The solution may largely consist of the historically-tested, orthodox one of quickly moving labor out of agriculture. With the large floating migrants in urban China, it is at best going to be a serious social, political and economic challenge for China to bring about quick enough a reduction in agriculture's share of employment.

The other problem is for China to make orderly changes in macroeconomic policies to bring about a closer balance between the rates of saving and investment, stabilize the rate of investment at about the current level and thereby make the elasticity of domestic consumption with respect to GDP higher than it has been in recent decades. A consensus seems to have emerged among the highest leadership about the need for macroeconomic rebalancing along these lines. In the West the issue is seen largely as requiring an upward adjustment in China's exchange rate. Indeed a successful rebalancing of macroeconomic aggregates would result in an upwards adjustment in the real exchange rate. But this would be the outcome rather than the starting point of public policy. For the share of private consumption expenditure in GDP to increase, it would be necessary for the share of personal income in GDP to rise, along with a decline in the personal propensity to save. The former would require a much faster increase in real wage rates than in the past while the latter would require the institution of social protection including at least a minimal public health service, unemployment insurance and old-age pensions. In the successful East Asian cases the rise in the real wage rate at approximately the same rate as per capita GDP was possible because of the high employment intensity of growth and the rapid exhaustion of surplus labor in agriculture, areas in which China's performance has been poor for historical reasons discussed above. With the prevalent surplus of labor in the form of both floating migrants and an excessive share of agriculture in the labor force, China will find it harder to institutionalize a rapid and orderly rise in real wages. The institution of social security can of course start immediately; but the process of setting up such institutions takes time. Even the experience of the successful poverty-reduction precedents in East Asia was not always so good in this respect. To bring quickly to halt the inexorable rise in capital export and the accumulation of external financial resources with low returns, an interim policy of massive public expenditure directed to poor areas and poor population seems unavoidable.

October 2010