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Editorial

Inequality, growth and the middle-income trap in China

More than three decades of high economic growth has transformed the Chinese economy. As China has quickly gone from a low- to middle-income country, it is now facing new challenges such as high income inequality and limitations in the growth model that has been so successful since the beginning of the economic reforms. A continued reliance on the old growth model may result in an increase in social instability due to what can be perceived as too high inequality and the inability to maintain growth due to the over-reliance on investment, which in a worst-case scenario could lead to China ending up in its own form of middle-income trap.

Under this context, Stockholm China Economic Research Institute, Stockholm School of Economics, and China Center for Economic Research, National School of Development, Peking University jointly organized a Conference on Inequality, Growth and the Middle-Income Trap in China, on July 1–2, 2013, at Peking University. The seven papers in this special issue presented at the conference cover a range of different perspectives on inequality, growth, and the middle-income trap. Each of them makes clear contributions to the policy-making process in China and together they provide an overview of some of the most important challenges that policymakers in China are facing in the pursuit of rebalancing the economy and sustaining economic growth.

The first contribution by Johansson and Wang analyzes the relationship between financial sector policies and inequality. Using a large country panel data set, it explores whether a variety of repressive financial policies act as drivers of inequality as such policies may distort capital allocation and limit economic opportunity. Using a series of panel data regressions and robustness checks, they find that repressive financial policies are positively associated with inequality. They also look at individual policies and identify credit controls and entry barriers in the banking sector as the two most important policies that influence inequality. In the case of China, these empirical findings have important policy implications, not the least because a variety of repressive financial policies are still in place while the country has experienced a significant increase in inequality during the reform period.

In the second paper, Du et al. study the two main channels for paternal income's effects on children income inequality in China: the composition effect and the income structure effect. To take potential endogeneity into account, the authors employ an instrumental variable quantile regression model on data from the China Health and Nutrition Survey (CHNS). Their findings suggest that the composition effect accounts for at least 80% of the income difference at any quantile and all the income difference in the higher deciles. Du et al.'s findings have several policy implications. For example, they show that redistributive policies and policies aimed at providing equal opportunities for the acquisition of human capital could help children escape a poverty trap and decrease current levels of inequality.

The third study by Eriksson et al. addresses the issue of intergenerational inequality in China. Similar to Du et al., the authors use data from the CHNS, but instead focus on the correlation of health between parents and children in urban and rural settings. Having controlled for various socio-economic status variables, demographic traits, environmental and health care factors, and unobserved household heterogeneity, they find that children's health is strongly correlated with the health of their parents. They also find that the existing income inequality between the urban and rural population is mirrored in intergenerational health inequality and they estimate that inequality among children would be 15–27% lower if no disparities existed between urban and rural parents' health. The main policy implication of this study is that policies aimed at reducing the importance of parents' resources on their children's health would lead to an improvement in overall health as well as help reduce the urban–rural health gap.

In the fourth paper, Zhang et al. contribute to the research on poverty levels in China by estimating and then comparing poverty incidence rates from four nationally representative surveys: the China Family Panel Studies (CFPS) of 2010, the Chinese General Social Survey (CGSS) of 2010, the China Household Finance Survey (CHFS) of 2011, and the Chinese Household Income Project (CHIP) of 2007. They compare poverty prevalence levels at the national, rural, and urban levels and come to the conclusion that poverty rates at all levels vary significantly depending on the data source, with the poverty rates being much higher when using data from the CFPS, CGSS, and CHFS compared to official estimates based on the CHIP. The official survey has undersampled the poorest group, resulting in lower estimates for poverty incidences. The practical implications of the study are significant as it sheds light on the importance of validating poverty estimates in China using independent data sources.

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Similar to the paper by Johansson and Wang, the fifth study by Huang et al. uses a cross-country panel set, this time to analyze the relationship between financial policy and the middle-income trap. Their findings suggest that the effect of repressive financial policies on growth is dependent on the level of economic development: growth in low-income countries is not significantly affected, growth in middle-income countries is negatively affected, and growth in high-income countries is positively affected by financial repression. For middle-income countries such as China, the most important policies for repressing growth are found to be repressive policies that target credit, entry to the banking sector, security markets, and the capital account. They also find that strengthening law and order is fundamental for avoiding the middle-income trap. These findings have important implications for Chinese policy makers, even though the authors highlight the importance of being aware of specific actual conditions in China that may result in it deviating from the general picture found in a cross-country analysis of this sort.

In the sixth paper, Du et al. take a closer look at the effects of the so-called "growth-first strategy" in China, in which regional governments have emphasized the development of capital- and technology-intensive industries (the overtaking strategy) and the real estate sector in an attempt to boost regional economic and fiscal revenue growth. The empirical analysis in the paper confirms that the overtaking and real estate development strategies have contributed to economic balances in the form of overinvestment and under-consumption. They also find that the structures of income distribution and government expenditure act as mediating channels for the growth strategies in their effects on domestic imbalances. One of the main policy implications that can be drawn from the paper is that the development strategies need to be modified in order for China to be able to move from an investment-led growth model to a model characterized by a balance between consumption and investment. Following these findings, the authors also highlight the likely positive effects of recent policy implementations, including rises in minimum wages, improvements in labor market conditions, improvements in compulsory education, and the development of social security and medical insurance.

In the seventh and final paper of this special issue, Du et al. contribute to the debate on whether the state sector is advancing at the expense of the private sector in China. The authors' main argument is that instead of focusing on the growing size of the state sector, it is useful to analyze the further retardation of the already financially constrained private sector. Applying recently developed methods to measure total factor productivity, they find that the misallocation within the state sector and/or between the state and private sectors has increased over the period 1998–2007. This indicates that resources continue to be reallocated towards the more inefficient state sector in China. The policy implication is clear in that a decrease in resource misallocation would most likely result in a greater expansion of the overall activity in the Chinese economy.

In summary, the studies in this volume all have important policy implications for the continued work against inequality, understanding poverty, avoiding the middle-income trap, and dealing with economic imbalances in contemporary China. All of these are daunting tasks and we hope that the papers in this special issue can serve as a starting point for discussions on current and possible future policies as well as a stepping stone for further research in each of these areas.

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