Chapter 2:

Inequality: Recent Trends in China and Experience in the OECD Area

Introduction

Over the past two decades, China has moved towards a market-oriented economy. Such a transformation initially entailed a marked rise in inequality, which was an inevitable consequence of the transformation of the economy that has delivered a higher and more sustained growth in incomes than observed in any other major economy. Since around 2005, the government has increasingly focused on the creation of a more harmonious society. The new emphasis in government policy was implemented during the 11th Five Year Plan (2006-10) and has resulted in a reduction in inequality across a number of dimensions. By 2010, the number of people below the poverty line of $1.25 per day (converted at purchasing power parities) had fallen by more than 150 million from ten years previously, leaving just 6% of the rural population with incomes below this level. In addition during the period of the Plan, income inequality in the urban and rural population has fallen, the urban-rural income gap has narrowed and the lower-income provinces have started to grow more rapidly than higher-income regions. At the same time, the coverage of social protection systems has been widened and total spending on social protection has soared.

As Chinese incomes rise, the emphasis on social policy may shift towards reducing inequality by redistributing income. Indeed, by 2010, income levels in major Chinese cities, which house around one-quarter of the population, approached $12,000 per person when evaluated at purchasing power parities – an income level not far from that in a number of OECD member countries. Consequently, the experiences of policies designed to reduce inequality in the OECD area could become increasingly relevant for designing policies in China. Given that the level of inequality may not fall automatically as the economy grows, policymakers may thus be interested in the approaches to reducing inequality that have been adopted within the OECD area and the consequences that these policies may have had on inequality and overall economic growth.

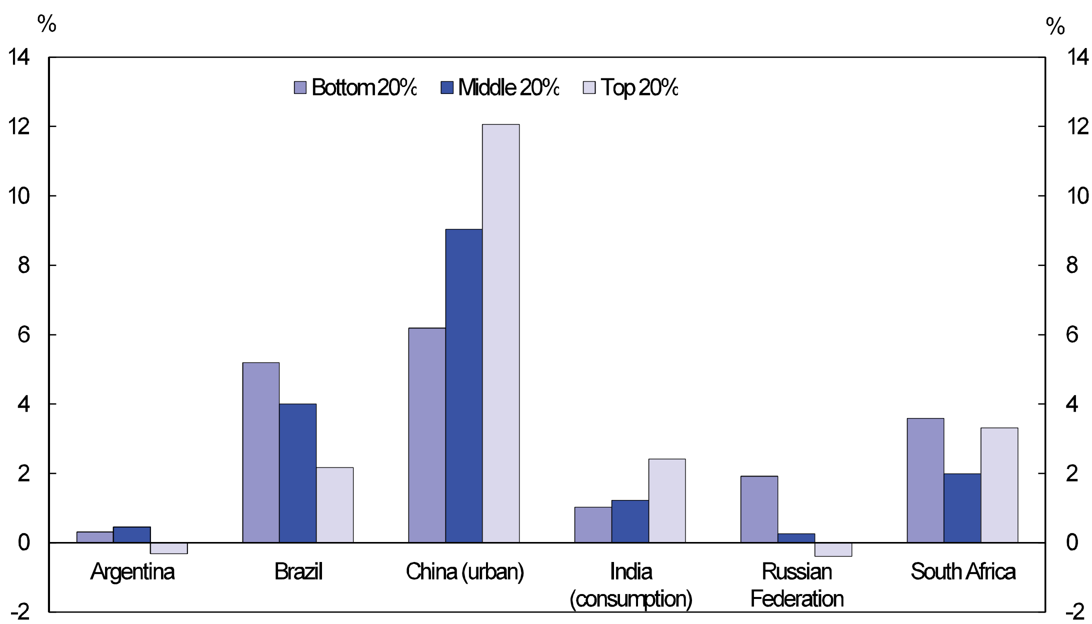
The remainder of this chapter first documents the movement in inequality in China over the period since reform and opening up gained momentum, focusing on developments since 2005. It then compares the extent of social protection and the social expenditure in relation to other emerging economies. Finally, the chapter considers the lessons with respect to growth and inequality that can be drawn from the experience of OECD members, focussing on the areas where it is possible to both reduce inequality and improve growth. This chapter draws on the results in two recent OECD publications *Going for Growth* and *Divided We Stand* and the related background papers.

Trends in inequality

As a result of the pace of transformation of the economy, the distribution of incomes changed much more rapidly in China than in other emerging economies. The extent to which the incomes of the higher quintile grew faster than the lower quintile was particularly marked in the urban areas of China, where they grew twice as fast (Figure 2.1). Nonetheless, the growth in the real incomes of the lowest quintile in China was more rapid than that of any quintile in the other emerging economies considered here, generating a very rapid decline in poverty.

Figure 2.1 **Change in real household income by quintile between the early 1990s and the late 2000s**[1]

Average annual percentage change



1. Figures for the early 1990s generally refer to either 1992vor 1993, while figures for the late 2000s refer to the period around 2008.

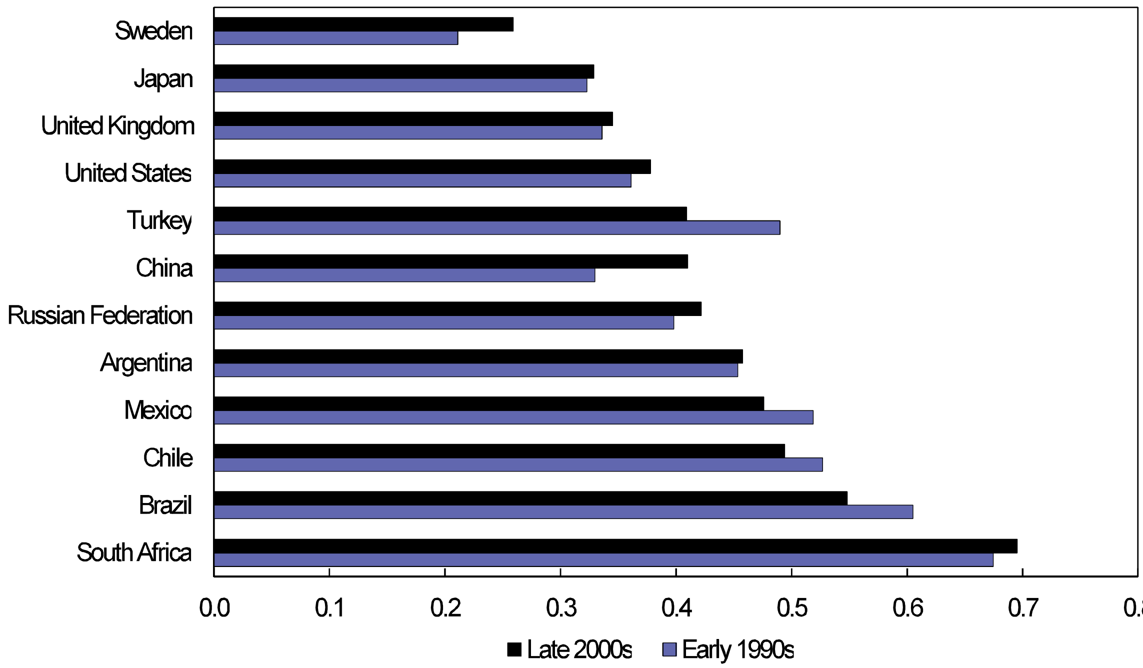
Source: OECD (2011a) -EU Database on EEs and World Bank Development Indicators Database.

In the early 1990s, China's income distribution was much more equal than that of other emerging economies. Although income disparities rose rapidly in China, by the end of the past decade the overall level of inequality in China was still lower than in nearly all the emerging countries, with only Turkey showing a marginally lower level. Inequality was higher, however, than that in the more advanced OECD countries (Figure 2.2).

In China, as the move towards a market economy became more complete, the rise in inequality eased. In fact, it appears to have stopped around 2005 and may have even been reversed in recent years, not least thanks to tax reform and improvements in the social safety net (Herd, 2010).

Figure 2.2 **Change in inequality levels, early 1990s versus late 2000s**[1]

Gini coefficient of household income



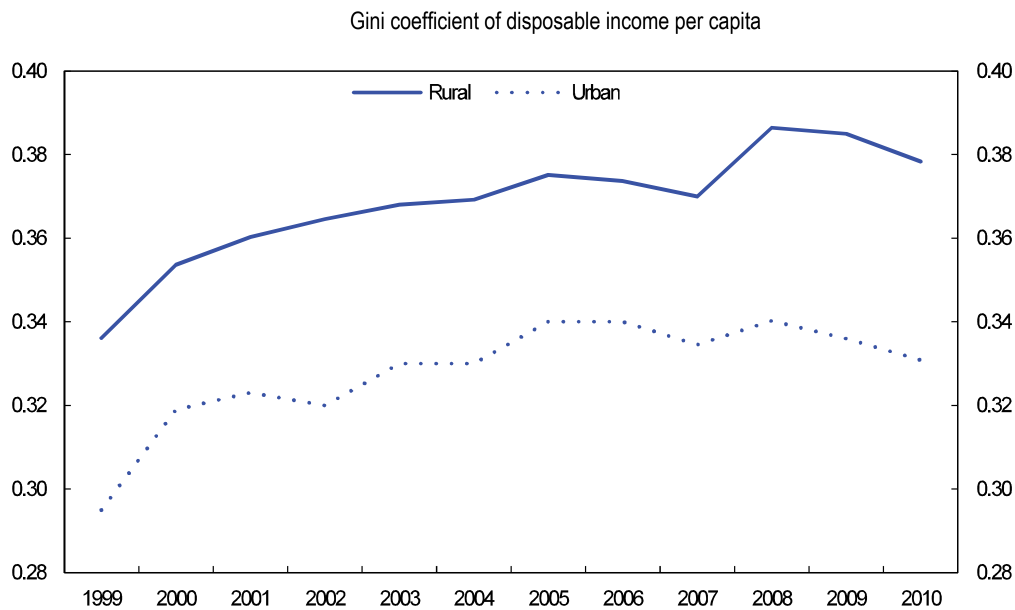
1. Figures for the early 1990s generally refer to 1993, whereas figures for the late 2000s generally refer to 2008.

Source: OECD-EU Database on Emerging Economies, World Bank Development Indicators Database.

In the period of the 11th Plan, the poorer groups in the urban areas experienced more rapid growth in income that the better-off groups, with the real incomes of the lowest decile rising by 10.6% annually against an increase of 9.3% for the highest decile. Such movements have resulted in a fall in the Gini coefficient in urban areas (Figure 2.3), though this movement may have been overstated by the increasing difficulty in sampling high-income households and obtaining accurate data about their disposable income. Inequalities in rural areas have also diminished, thanks to a number of government policies such as the removal of agricultural taxes and fees in 2006. More recently in 2010, government cash transfers to the lowest income quintile rose 30% from the previous year.

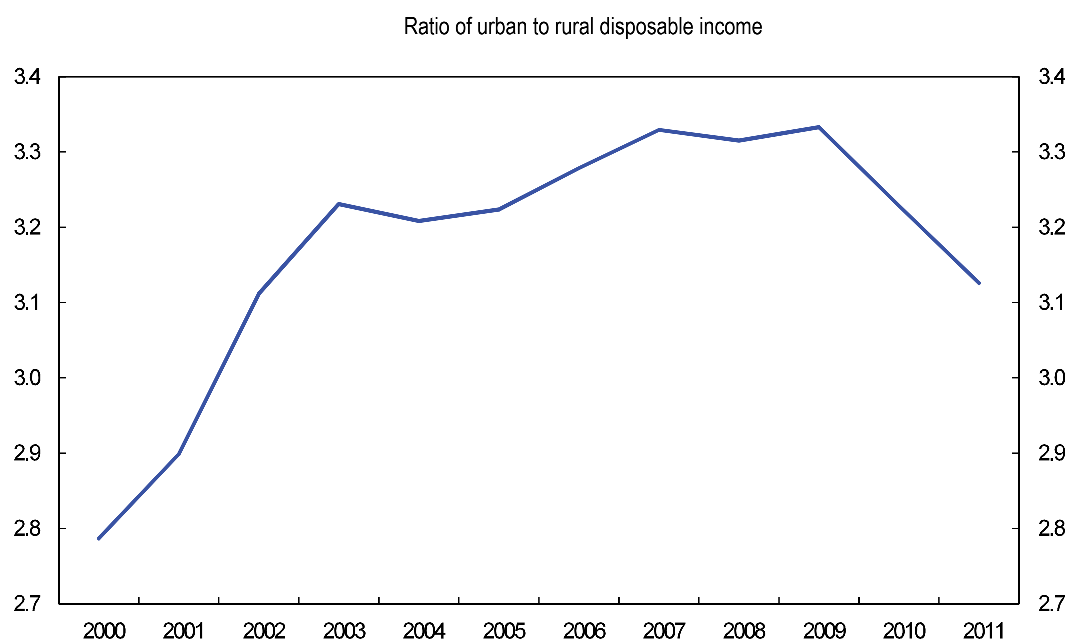
The difference between average incomes in rural and urban areas is an important determinant of overall national inequality in China and has fallen recently. The extent of this difference is particularly high in China and had been rising steadily until recently. By 2009, the ratio had reached 3.3, which is much higher than in other emerging economies such as India, where the ratio of consumption between urban and rural households was just under 2 in 2009. Since then, however, the rural-urban income gap in China has started to fall and by 2011 had dropped back to its level of 2003. The fall has been helped by a rapid increase in the number of migrants whose income is counted as being rural income, even if they are working in urban areas provided that their families remain in the countryside. There has also been a major increase in the extent of government transfers to the less well-off in rural areas. In addition to income discrepancies, there are great disparities in access to basic services, such as education, between rural and urban populations (OECD, 2010b).

Figure 2.3 **Inequality drops in urban and rural areas**



Source: National Bureau of Statistics and National Development and Reform Commission, except for urban incomes from 2008 to 2010 which have been estimated by the OECD.

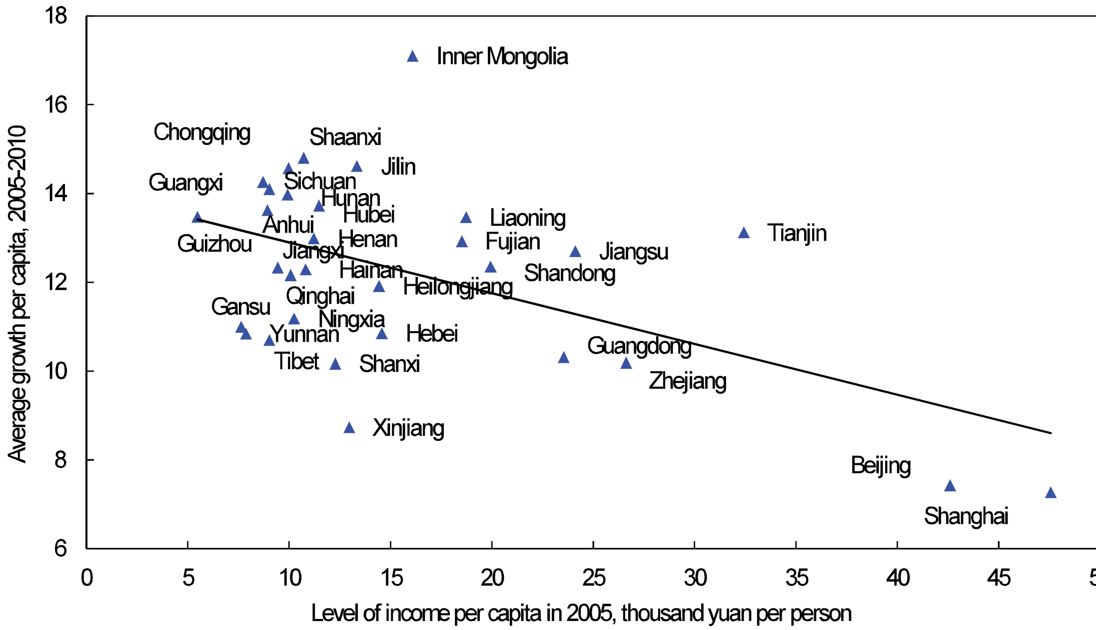
Figure 2.4 **The gap between rural and urban incomes narrows**



Source: ChinaDataOnline from National Bureau of Statistics.

Regional inequality has been declining in the past five years. The forces underlying regional inequality are difficult to disentangle and often overlap. They typically involve the interplay of geographic, historical and institutional factors such as weak resource endowments and distance from markets, which

Figure 2.5 **Low-income provinces have grown faster than high-income provinces between 2005 and 2010**



Source: GDP: CEIC; provincial population: National Bureau of Statistics.

constrain development in lagging regions. Nonetheless, in the five years to 2010, the extent of regional inequality has been declining in China. In part this development reflects rapidly increasing wages in coastal provinces which has incited companies to relocate factories away from coastal areas, as well as the emphasis on infrastructure spending in inland areas during the past five years (OECD, 2010c).

The causes of inequality in China

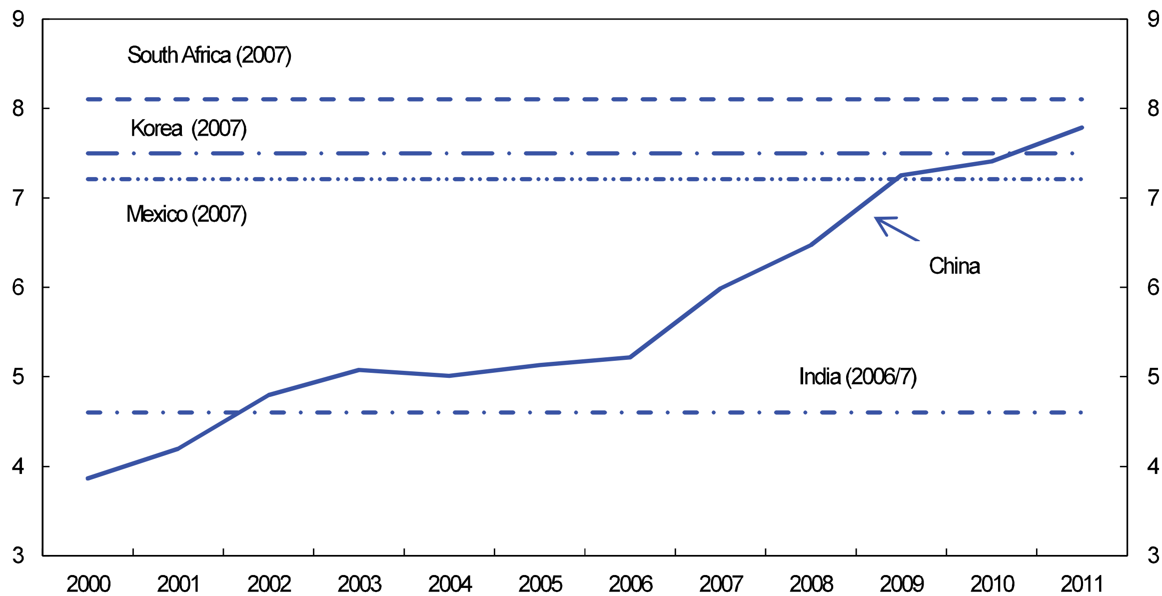
The key sources of inequality in China, as in other emerging economies, include geographical factors, a large and persistent informal sector, gaps in access to education, and barriers to employment and career progression for specific groups, particularly rural migrants. The inequality between rural and urban areas are linked with disparities in access to basic services – such as medical insurance and education (Herd, 2010) – and institutional factors – notably, the hukou system which prevents rural and urban migrants from acquiring the same rights as people with the local urban registration status in the area in which they live (Herd et al., 2010). The incidence of informal employment is also an important parameter of inequality and is related to the segmentation of labour markets.

The social protection system has been widened but is far from universal

Social policy has helped raise the incomes of the poorest groups in society during the past five years. Government social expenditure spending in China has been rising rapidly since 2006 reflecting the change in emphasis that started during the period of the 11th Plan. In the five years to 2011, social outlays have almost tripled in real terms, rising to nearly 8% of GDP. Such growth has pushed outlays above those in many emerging economies (Figure 2.6).

Figure 2.6 **Public social expenditure in China and selected emerging economies**[1]

Total public social expenditure as % of GDP



1. Policy areas covered include old-age and survivors pensions, incapacity-related benefits, family, health, active labour market policies, unemployment and in some cases (but not China) housing.

Source: OECD countries the SOCX database; for non-OECD countries other than China see Chapter 2 of OECD (2011a) and http://www.oecd.org/dataoecd/45/62/48654927.pdf ; for China: China Statistical Yearbook and CEIC.

On the other hand, social expenditure is much lower than in Brazil and Russia, where outlays on social programmes reach levels typical of countries with much higher incomes.

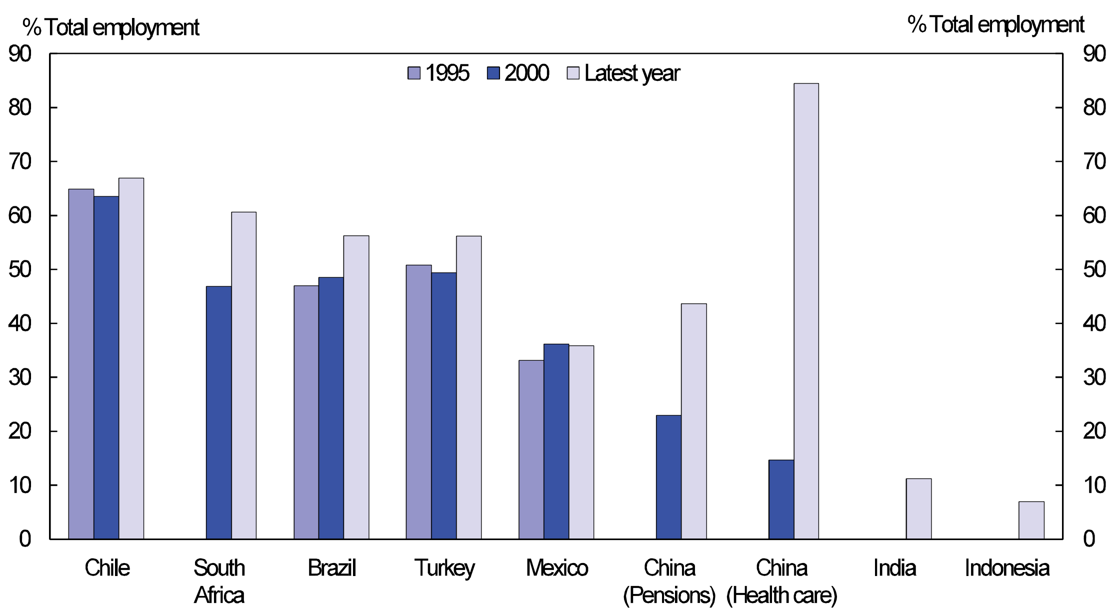
The bulk of the increase in expenditure in this period has gone towards extending the coverage of social programmes. Notable reforms include the generalisation of the minimum subsistence allowance to the countryside; new medical insurance schemes for people with rural registration status, for dependants of registered urban employees and students; the introduction of a new pension system for people living in the countryside and one for migrant workers. The result of the new policies has been a marked rise in coverage for the principal forms of social protection (Figure 2.7). During the 12th Plan period (2011-2015), the government expects to complete the roll-out of the pension system for people living in the countryside and to further extend social protection. The first actions during the 12th Plan included the introduction of a pension system for people in urban areas who are economically inactive and a 10% increase in benefit levels for those already retired at a cost of around 0.4% of GDP. Key challenges remain to be overcome. The average level of benefits under many of the rural social protection schemes is low and within urban areas many firms do not pay contributions for their staff as enforcement is poor and penalties for non-compliance are almost non-existent, so employees of these firms are not eligible for social benefits.

The system of unemployment insurance in China rests to a very large extent on severance payments determined by the labour contract of the employee. For those workers with labour contracts the severance payments are quite high. Indeed, if the severance pay for a worker with four years seniority is added to the total unemployment benefits payable in the first 12 months of unemployment, the total unemployment package is above the average of the OECD areas

(Figure 2.8). However, in 2010, only 4% of migrant workers were affiliated to the unemployment insurance system and less than half had a labour contract despite the new labour law. As a result, the proportion of the unemployed receiving benefits is under 10%, slightly below the average in emerging economies. The extent of informal or semi-informal employment limits the ability of unemployment insurance systems to prevent unemployment-related poverty and inequality and increases the importance of informal insurance mechanisms. It may also impose higher adjustment costs on people who return to work and may represent an inefficient use of resources when individuals are credit-constrained.

Figure 2.7 **The coverage of contributory social schemes has risen substantially**

Affiliation to social security

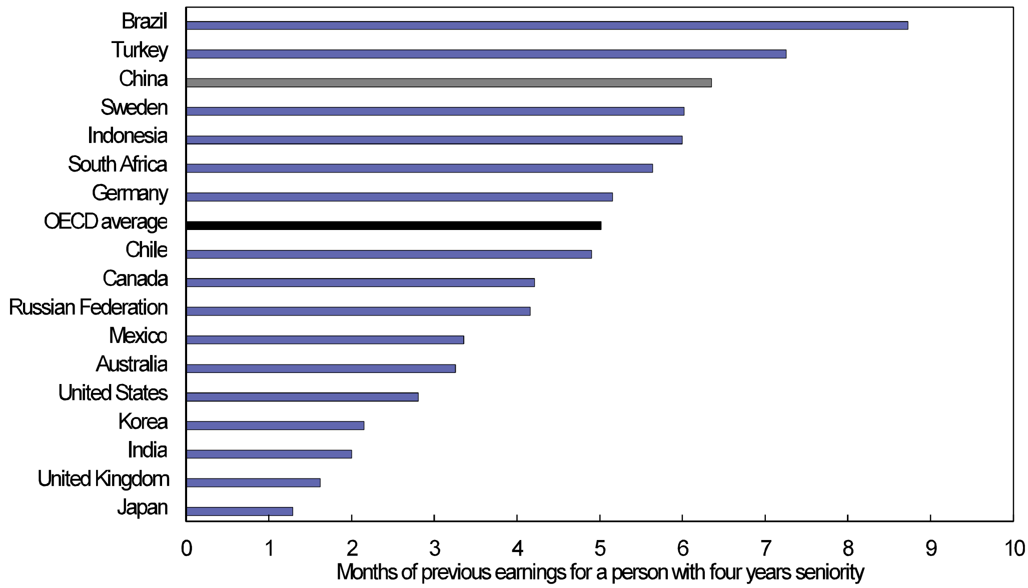


The year of reference varies slightly from country to country.

Source: OECD calculations based on various sources for non-member countries (same as Figure 2.6) and National Bureau of Statistics (2011) for China.

There is evidence that persistent informal economic relations lead to greater income inequality (Jütting and de Laiglesia, 2009). In China, this outcome reflects the interplay of several forces. First, informal jobs typically carry a wage penalty. Migrants' pay was two-thirds that of registered urban employees in 2010, though half of all migrant workers had free accommodation. The gap in hourly earnings was even larger as migrants worked far more hours, though part is accounted for by the lower human capital of migrants. Second, informal jobs are much less stable than formal ones. Third, employers do not register migrants for social security. Fourth, informal jobs considerably limit opportunities for human capital accumulation and career progression. Furthermore, employment in the informal sector can also be detrimental to a worker's subsequent prospects for formal employment, thereby entrapping the low-skilled and contributing to the persistence of income inequality.

Figure 2.8 **Unemployment and severance pay benefits**

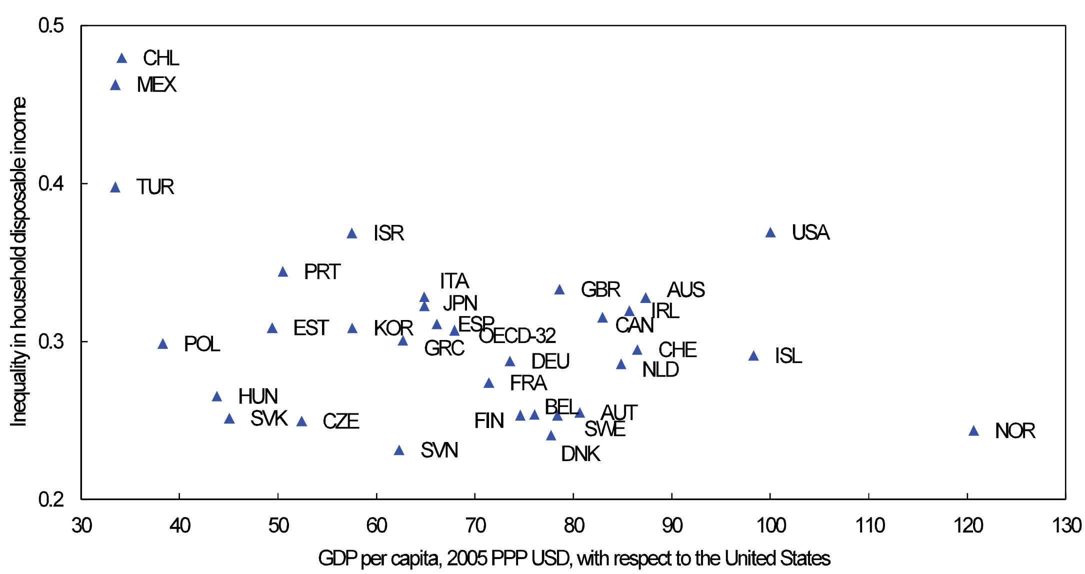


Source: OECD (2011b).

The impact of taxes and cash transfers policies on inequality in the OECD area

Across the OECD area, there appears to be little relation between the level of economic development and the extent of inequality. Countries with as diverse levels of economic development as Poland and Switzerland have similar levels of inequality. Such a result has also been found across countries with lower income levels than China (Deininger and Squire, 1998).

Figure 2.9 **Inequality and income levels across OECD countries**

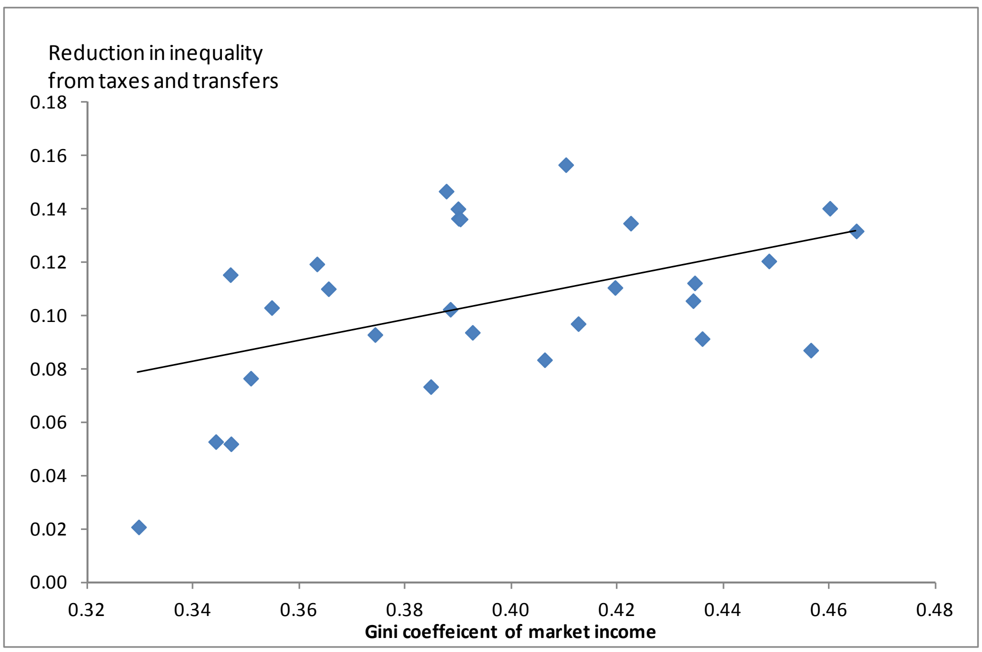


Source: Hoeller *et al.*, (2012)

These results suggest that policymakers should not rely on any automatic tendency for inequality to decline as their economy develops. Rather specific policies to boost the incomes of poorer households may be needed.

Within the OECD area, the redistributive impact of taxes and transfers varies: countries with a more unequal distribution of market income tend to redistribute more, though there are exceptions (Joumard et al., 2012). Cash transfers reduce income dispersion more than taxes in most OECD countries. On average, three quarters of the reduction in inequality is due to transfers, the rest to taxes.

Figure 2.10 **Redistribution tends to be higher when incomes are more unequal**



Note: The best fit line is given y = -0.032 + 0.342x. The t statistic on the x variable is 3.0

Source: OECD Income and Poverty database

There is no single redistributive strategy favoured by OECD member governments. Countries have adopted a wide range of policies. In some, cash transfers redistribute income mainly over the life-cycle rather than across individuals and often account for a large share of household disposable income. Old-age pensions often fall into this category – and their progressivity is low in many countries, as the distribution of pensions reflects the initial distribution of incomes. Countries with lower outlays on cash transfers tend to rely more on targeted benefits. A few rely to a very limited extent on cash transfers to reduce income inequality. In most countries, the most progressive benefits are family and housing benefits, though their redistributive impact is limited as they are often small in size. Disability and unemployment benefits reduce income inequality although their progressivity largely depends on their design.

The cross-country variation in the redistributive impact of household taxes is more limited than that of transfers, despite large differences in tax-to-GDP ratios. High-tax countries tend to have less progressive household taxes. The progressivity of labour taxes (including social security contributions) has increased in the majority of OECD countries but mainly at lower income levels.

Personal income rate schedules have often become flatter reflecting the steep decline in top marginal tax rates, but working against this social security contributions for low-income earners have been cut and earned income tax relief has been introduced in attempts to reduce the adverse impact of high labour taxation and dual labour markets on young workers. On the other hand, the redistributive impact of tax systems has been reduced by the reduction of the taxation of capital income and wealth. The most progressive tax is that on personal income, though there are significant cross-country variations. The most regressive taxes are social security contributions, consumption taxes and real estate taxes.

Complementarities between policies to reduce inequality and boost growth

In a number of areas, there is clear evidence that policies designed to reduce inequality can also boost growth. The clearest example is education policy. Human capital formation should be facilitated in order to boost growth but the key for reducing inequality is to ensure that the educational potential of an individual should be made less dependent on her/his personal, social and geographic background. There is clear evidence in OECD countries that the completion of secondary and tertiary education boosts income and this holds in China too (OECD, 2010c). Equally, all forms of discrimination should be avoided so that the labour market participation of women and elderly people is raised, as gender differences in working hours and choice of occupation and sector account for a sizable part of the earnings gap. Policies to reduce these differences (*e.g.* improvements in the access to childcare) could thus lead to more equal labour market outcomes among men and women while boosting long-run growth. Addressing inequalities in both access to, and quality of, education can be expected to help lower inequality in labour income. This is especially the case in China, where education is seen to play a major role in shaping household income differences between urban and rural areas, mainly because the education levels are different but also because the related returns are higher in cities with education helping rural people to move to cities. In addition, education needs to be complemented by policies to ensure a smooth transition from school to work especially for disadvantaged youth (mainly from poor households) so as to ultimately achieve a more equal distribution of income for the future generations.

Chinese policymakers should also note that there is evidence from OECD countries that long-run growth can be boosted and inequality reduced by integrating migrants into the labour force and avoiding labour market dualism. This is particularly important for China. While international migration is not sizeable, there is a need to integrate internal migrant workers into the local population, both with respect to eligibility to existing social safety nets and with respect to education, where OECD experience is that inequality can be reduced by ensuring that access to all levels of education is independent of the family background of individuals.

Policymakers in China also need to guard against entrenched labour market dualism, which places much of the adjustment burden on those in the informal part of the economy. In part this already occurs in China, where employment protection legislation of permanent workers is particularly stringent compared with other emerging economies and many OECD countries, but has a limited reach among vulnerable groups such as workers in the informal sector and rural migrants because of weak enforcement (Herd *et al.*, 2010), so that employment protection legislation may possibly worsen the income distribution. Reducing labour market dualism by narrowing the gap between the protection of permanent and temporary employees should help reduce income inequality through both a lower wage dispersion and lower unemployment. Evidence from the OECD area suggests that lowering the protection of permanent employees reduces inequality. In China, there are also regulations that limit the use of temporary and fixed-term contracts. Relaxing restrictions on the use of such contracts and reducing firing costs for young or inexperienced workers may improve incentives for firms to hire workers on a formal basis. In some cases in the OECD area, partial reforms of employment protection laws may have resulted in "two-tier" systems with high unemployment turnover for certain categories of workers but still high overall unemployment. In the Chinese context, the dual labour market is evidenced both by the exclusion of many workers from the social security system and by the markedly higher wages paid by the state-owned enterprises where they are operating non-competitively.

Given that strict employment protection legislation reduces outflows from unemployment, OECD experience suggests that there is a case for easing strict regulation on regular contracts, especially where unemployment benefits are high and extended, or where unemployment persistence is a problem. Furthermore, a dual labour market amplifies shocks. Hence, narrowing the differences in the degree of employment protection between different types of workers, for instance by unifying contract types with protection rising with seniority, could boost hiring during the recovery while at the same time improving labour market resilience to future shocks and lowering the unemployment rate in the longer term.

Taxing in a way that allows equitable and inclusive growth

OECD experience suggests that there are a number of areas where there is a tension between the desire to reduce inequality and the objective to promote economic growth.

The clearest example from within the OECD area is that inequality can be reduced by policies that set high marginal tax rates on top incomes, wealth, inheritance and transfers of capital between living individuals. However, there is evidence from within the OECD area that high marginal tax rates could undermine incentives to work, save and invest, which can adversely impact long-run growth (OECD, 2012). So far, tax policy is oriented to raising growth rather than reducing inequality by keeping marginal income tax rates low. For example, the highest marginal tax rate (45%) only applies to incomes more than 34 times the average wage, with the marginal income tax rate for the bulk of the population is zero since September 2011 when marginal income tax rates were reduced to zero for 60 million taxpayers, leaving only 24 million people (3% of the working population) paying income tax on labour income. Income from investment in bank deposits and many bonds is not taxed at all while other forms of property income, including capital gains, are taxed at 20%. A low income tax burden also has positive effects on economic growth as it enhances entrepreneurship and encourages foreign direct investment and education.

However, OECD experience also suggests that there are policy options that could yield a double dividend by promoting growth and reducing inequality at the same time (Table 2.1). Cutting back tax expenditures that benefit mainly high-income groups (e.g. tax relief on mortgage interest) is likely to be beneficial both for long-term growth, allowing a reduction in marginal taxes, and for a more equitable distribution of income. Other possible options are aligning the taxation of owner-occupied residential property more closely with actual values and returns and a closer alignment between the tax treatment of capital gains and ordinary income.

Equally, OECD experience suggests that growth can be boosted by shifting the tax mix to less-distorting taxes – in particular away from labour and corporate taxes to consumption taxes (OECD, 2011d). Model simulations in Table 2.1 suggest that shifting the tax burden away from direct taxes towards consumption taxes reduces unemployment relatively quickly, particularly so for youth and women (Ahrend *et al.*, 2011). After a few years, such reforms also appear to trigger stronger female and youth participation. This indicates that improving the tax structure can have positive labour supply and labour demand effects (OECD, 2011e). Moreover, empirical results suggest that such reforms also boost private investment. The Chinese tax system is already based on indirect taxation, with only one-third of total tax revenues coming from income tax and social contributions. At the same time, taxes on consumption are associated with a widening gap between the rich and poor. However, other changes in the tax or benefit system could be used to offset some of these effects on inequality such as applying a reduced VAT to necessities and providing targeted benefits to those most in need. All in all, under current conditions, the role of taxes in income redistribution remains limited. Changing this situation is likely to take time. In China then, for the time being, reducing inequality is better addressed through well-targeted social welfare programmes. In-work tax credits that targeted the low-income groups, for instance, can narrow the income distribution and raise incentives to work.

Table 2.1 **The impact of tax reforms on growth and equality**

+ means more and - means less equality or GDP per capita; ~ denotes an ambiguous effect

Tax policies	Income equality	GDP per capita	Comments
Increasing total tax revenues	+ (in general)	-	• The impact of taxes on income distribution depends on the level of taxation, the tax mix and the use of tax revenues, but if tax systems are progressive overall, equality is enhanced. • Taxes dampen incentives to work, save and invest and are thus detrimental to growth. But some taxes have a less adverse effect than others.
Changing the tax mix while keeping total tax revenues constant			
Moving from personal income tax to consumption taxes	-	+	• Personal income tax tends to be progressive while consumption tax is regressive. • Personal income tax reduces work and saving incentives. A shift from direct to indirect taxes would raise GDP per capita.
Moving from labour income to property and capital taxes: • to wealth, inheritance and capital income taxes, such as capital gains taxes • to real estate taxes	~ -	+ +	• Wealth and inheritance taxes tend to be progressive. • The distributive impact depends on the relative progressivity of income versus wealth and inheritance taxes. • Real estate taxes are often less progressive than the personal income tax and can even be regressive. • Property taxes are among the least harmful for growth. Moving from income to property taxes tends to improve incentives to work and invest, and thus to raise output, at least in the short and medium term.
Cutting tax expenditures and marginal rates	+ (in most cases) - (for in-work tax credits)	+	• Most tax expenditures benefit high-income groups (in-work tax credits and other tax expenditures targeted at low-income groups are the exception). Cutting tax expenditure would narrow the distribution of disposable income. • Cutting marginal rates improves incentives to work, save and invest, and thus lifts GDP per capita.
Increasing the progressivity of taxes (revenue-neutral) Personal income tax: • increase in top rates • above measure combined with expanded EITC schemes or tax free allowances	+	~	• In-work tax credits narrow the income distribution and raise incentives to work. • On the other hand, higher top rates may reduce working hours and productivity by undermining incentives to learn, invest and innovate. • The GDP per capita impact is thus ambiguous.

Source: Joumard et al. (2012).

Dealing with the distributional consequences of short-term output fluctuations

While long-run movements in inequality are of concern, OECD policymakers have also been concerned with the short-term consequences of output fluctuations for income distribution. In general, individuals on lower incomes are found to have been more strongly affected by fluctuations in economic activity than other income groups, suffering more from adverse shocks, but at the same time often benefiting more from positive ones (Table 2.2).

Table 2.2 **Synthesis of empirical findings on the distributional impact of macroeconomic shocks**

Financial crises	
	increase the income share of the 3rd and 4th quintile
	reduce the income share of the 5th quintile
	increase poverty
	worsen the relative labour market outcomes for
	youths (unemployment , employment),
	seniors (unemployment)
	women (employment)
	improve the relative employment performance of those with tertiary education
Fiscal consolidations	
	reduce the income share of the first 1st and 2nd quintile
	increase inequality (Gini coefficient)
	increase poverty
	worsen relative labour market outcomes for
	youths (unemployment, employment)
	seniors (employment)
Fiscal expansions	
	increase the income share of the 1st and 2nd quintiles
	reduce the income share of the 5th quintile
	reduce inequality
	reduce poverty
	increase income share of youth
	increase income share of pensioners
	enhance relative labour market performance of
	youths (unemployment)
	seniors (unemployment, employment)

Source: Ahrend et al. (2011).

As China has become more open and interlinked with the economies of the rest of the world, it has become more vulnerable to external shocks in addition to the disturbances that can arise from within its own economy. The labour market in China has proved quite resilient to external shocks, especially those stemming from the 2008 financial crisis when there was neither an increase in the unemployment rate nor a increase in the extent to which people withdrew from the labour force and became economically inactive. Within the OECD area, countries rely on different types of institutions to cope with shocks:

- Some provide income risk sharing mainly via social-protection institutions: most continental-European and (possibly to a lesser degree) eastern-European countries are likely to offer a higher degree of income protection to lower-income households in the wake of negative shocks, at the risk of generating poor labour-market performance of youth and labour market outsiders.
- Some rely mainly on reallocation-facilitating institutions: English-speaking and Asian OECD countries would typically fall in this second group and provide less redistribution.
- Some rely strongly on both of them: these are mainly Nordic countries, which typically combine strong reallocation-facilitating institutions, including active labour market policies, with well-developed social insurance. However, there are efficiency losses associated with the high marginal tax rates necessary to finance this model.

The institutional structure in China corresponds most to that seen in the second group of OECD countries. Unemployment benefits are relatively low and the response of the authorities to the labour market problems of 2009 was mostly through measures to facilitate the re-insertion of workers that had lost their jobs (OECD / ILO, 2011).

The influence of institutions on the distributional implications of shocks

Analysis of the above sets of policies suggests that there is no one best set of policies designed to reduce the distributional impact of a downturn in the economy. Some policies that work in the short term may have undesirable consequences in the long term while other policies may have differing impacts on efficiency. Nearly always, it is a case of balancing equity and efficiency and the short and long term. The weights that different countries attach to these elements differ. However, an analysis of the policies in place in the OECD area may be of interest to Chinese policymakers as they continue to reform their social safety net.

The balance between a short-term gain in equity against longer-term loss in efficiency can be seen clearly in the experience of countries with high levels of unemployment benefit. The negative impact of macroeconomic shocks on poorer segments of society can been dampened by generous unemployment benefits, especially for the initial period of unemployment, but such transfer payments generate a risk of adverse employment effects for certain groups, raising both the level and duration of unemployment, unless effective activation strategies for the unemployed are also in place.

A common finding across countries is that other policies designed to dampen the impact of the macro-economic fluctuations have an adverse impact on youths. Stricter job protection is found to have provided some income protection for lower and middle-income classes in the wake of negative shocks but at the expense of youth employment. Equally minimum wages are found to have beneficial effects on inequality in the wake of certain shocks, but again often with the opposite effect on youths.

On the other hand, a number of policies can help mitigate the impact of downturns on youths. China already has one of the best-performing youth labour markets amongst G20 countries in terms of integrating young people into the labour market, with their unemployment rate being twice that of the adult population (OECD / ILO, 2011). In the OECD area, lower tax wedges on labour income are one example of a policy that can help youth employment. In China, many young workers effectively face a tax wedge of zero. There is a range of evidence suggesting that high-quality vocational education pathways in upper secondary education can help engage youth who have become disaffected with academic education and thereby improve graduation rates and ensure smoother transitions from school to work. Countries with a long tradition of apprenticeship systems, such as Germany, have a good performance in terms of low youth unemployment. Indeed Germany is one of only two other countries in the G20 that match the performance of the Chinese youth labour market. Important steps have been made in China to enhance the employment prospects of youth and migrants through vocational training and incentives provided to employers to retain or hire among vulnerable groups. In addition, complementary career guidance can help youth make better informed decisions during their school-to-work transitions and about their future, provided that it is effectively designed and implemented. Notably it requires: *i)* early action in lower secondary education; *ii)* highly qualified guidance personnel; and *iii)* timely and high-quality data on local labour market needs and employment prospects by occupation (OECD, 2010a; and OECD, 2011b). Such programmes are urgently needed in higher-education institutions where there is evidence that many graduates are unable to find jobs that match their expectations, following the massive expansion of higher education in the past five years.

The orientation that Chinese policymakers would want to give to policies designed to improve the social safety net will depend on the balance that is struck between equity and efficiency. One key aspect of improving the social safety net will be widening the coverage of unemployment benefits and the minimum living allowance to all people who have lived and worked in a given area. Currently unemployment benefit levels are set locally. They vary between the level of the minimum wage and the guaranteed minimum living income, which is also set locally. Although its coverage increased substantially in recent years, a majority of poor households remained uncovered. Fiscal constraints enter into the determination of local poverty lines by local governments, with the implication that entitlements cover only part of the poverty gap. In 2011, the government announced an 80% hike in the poverty line and set a goal of meeting the food, clothing, education, basic health and housing requirements of the poorest people by 2020. Extension of benefits to the migrant population could have a significant impact on equity and increase the share of the lower incomes in the value of output. OECD experience shows that such an extension should be accompanied by strategies for ensuring a swift return to work through improving information flows in the labour market. The experiences of Brazil with *Bolsa Familia* and Mexico with *Oportunidades* may offer useful insights to the Chinese authorities, including on the introduction of conditionalities. By combining income support to those mostly in need with investments in health and education they can play a major role in reducing poverty and enhance the future (labour market) opportunities of poor households.

To ensure social stability, policies designed to protect one group in the labour market should not have a marked adverse impact on other groups. In China, this would point to careful evaluation of policies designed to increase minimum wages. Minimum wages can improve inequality outcomes in downturns but can also result in fewer employment opportunities for the marginal workers, which in China would be the poorer migrant workers from the central and western provinces.

Reforms in product markets can also improve the income distribution

The extent of regulation of product markets has been found to be a driver of long-term growth. This has been confirmed by analysis of the changes in the regulation in network industries. Such structural reform has also lowered inequality. Cross-country time-series evidence on product market reforms in transport, energy and communication industries in the OECD area suggests that they increase employment (Fiori *et al.*, 2012). Inequality is reduced by this type of structural reform through the boost given to labour force participation and employment.

While it is difficult to document that structural reform in network industries raises labour force participation in China, there is clear evidence that reducing the extent of regulation in non-manufacturing network industries brings productivity gains, even in the short term (Bas and Causa, 2012). It also appears that trade liberalisation spurs manufacturing productivity growth, especially for domestically-owned firms. Within the OECD area, better product-market regulation is found to have a particularly positive effect for youths and the poorer segments of society in the wake of macroeconomic shocks.

In the Chinese context, this work suggests that there is scope for increasing productivity and employment by introducing more competition into network, energy and transport industries that are largely controlled by state-owned monopolies or oligopolies. If the effects on labour force participation are similar to those observed in the OECD area, then reform of these sectors where competition is restricted would have beneficial impacts on labour force participation, thought the impact on inequality is ambiguous. In addition, while lifetime employment has been ended in state-owned enterprises, there appears to be a significant discrimination against migrant workers in the employment policies of these companies.

Financial reforms as well can have redistributive effects

Financial market reforms that make it easier for firms to rely on external finance are also tentatively found to bring productivity gains relatively quickly in catching-up economies. Firm-level evidence for China also shows that such reforms are more beneficial to firms that are relatively far from the technological frontier, implying that they help speed up the catch-up process within industries (Bas and Causa, 2012).

However, financial reforms may amplify the redistributive effects of various shocks insofar as financial market sophistication makes for more pronounced credit cycles. Financial crises have tended to affect the incomes of the low and high-income households most strongly, while the middle class has tended to improve its relative income position. The effect of macroeconomic shocks varies also across age groups. Labour-market performance of youths has been particularly poor in the wake of almost any negative macroeconomic shock. Older households have been disproportionately affected by large changes in the fiscal stance. Financial crises have often been associated with house price declines. Highly-leveraged households and those whose asset portfolios primarily consist of housing assets, *i.e.* households in the 26-35 year old group, are most vulnerable in such cases. Such consequences flowing from financial reform strengthen the case for strong macro-prudential regulation which should amongst other factors limit excessive leverage - including for house purchases.

Conclusions

The extensive analysis of inequality and inclusive growth, dealing with both the economic ramifications and the social effects produced in publications and seminars by the OECD over the past year points to the strong complementarities between a number of policies that can serve to improve growth over the longer term and which at the same time can reduce inequalities. Improving access to education and removing barriers that give rise to discrimination between people of similar qualifications and abilities in the labour market are examples. Reducing such constraints boosts the average level of incomes but also tends to draw more people into employment and can reduce the extent of rent-sharing between employees and employers in the protected sectors. In the context of China, such analysis confirms to the urgency of reducing discrimination against the quarter of a billion of migrant workers and their families. It also shows that introducing more competition into sectors where a few state-owned enterprises hold dominant market shares would both contribute to reduce inequalities and boost long term growth.

The analysis produced over the past year has also suggested that there are policies that can promote growth and reduce inequality. Improving tax compliance and abolishing tax breaks that benefit high-income recipients, for instance, are efficient ways to achieve both. Tax systems based on indirect taxation are more growth-friendly than those based on direct taxation. At the same time, to contain inequality, China should continue to improve its social safety nets, but in doing so it needs to guard against potential work disincentives. The efforts and successes of China will become increasingly relevant to informing the continuing work of the OECD in its work on inequality and inclusive growth.

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