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China's Common Prosperity Drive

By Bert HOFMAN

Earlier this year, China celebrated the eradication of extreme poverty. Since the start of reforms hundreds of million people managed to escape poverty on the back of reforms that generated high growth, employment and income opportunities. In the past decade, this was further enhanced by a massive government programme to target all the then-remaining 90 million poor. By any standards, this was a remarkable achievement and of global significance as China's poverty reduction was a big part of meeting the Millennial Development Goals of the UN.

Deng Xiaoping, at the launch of the Coastal Development Strategy in 1986, had famously said, "*Our policy is to let some people and some areas get rich first to drive and help the backward areas; first advanced areas later have the duty to help the backward areas"*. Most had forgotten about the second part, but not the Communist Party of China. Last week, the Central Committee on Economy and Finance, chaired by Xi Jinping, announced that "common prosperity" was to be the new goal.

This new objective did not fall from the sky. Rising income inequality has been a topic for debate since reforms began. Deng's approach at the time was controversial with party hardliners, some of whom preferred equality in poverty over progress. Deng's statement put an end to the debate and the focus on economic growth first, which on hindsight seems a wise choice.

The Decisions of the Third Plenum of the Central Committee in 2013, which focused on economic reforms, had stated: "We will improve the regulatory mechanism of income redistribution mainly by the means of taxation, social security and transfer payment and enhance the regulatory role of taxation…..We will regulate excessively high incomes, redefine and clear away hidden incomes, outlaw illegal incomes, increase the incomes of low-income groups, and increase the proportion of the middle-income group in society as a whole", words not dissimilar to those included in the report on the meeting of the Central Commission on Economy and Finance on 18 August 2021, which announced the policy change.

With the "moderately prosperous society" achieved, the goalposts are shifting. Last year, at his annual post-NPC press conference, Premier Li Keqiang had remarked that "[t]he average per-capita annual income in China is RMB30,000 (USD4,193), but there are over 600 million people whose monthly income is barely RMB1,000 (USD140), not enough to rent a room in the Chinese cities". China's official poverty standard is about RMB3,500 per year. On the other end of the spectrum, as James Kynge points out in his *Financial Times* article on the end of China's Gilded Age, China now has more billionaires than the United States.

Already in November 2015 Xi Jinping, at a Central Party Committee study session titled "Constantly open up a new realm of contemporary Chinese Marxist political economy", had things to say about income distribution: "Due to various reasons, there are still some outstanding problems in the current income distribution in our country, mainly the widening income gap, the low proportion of labour remuneration in the primary distribution, and the low proportion of residents' income in the national income distribution".

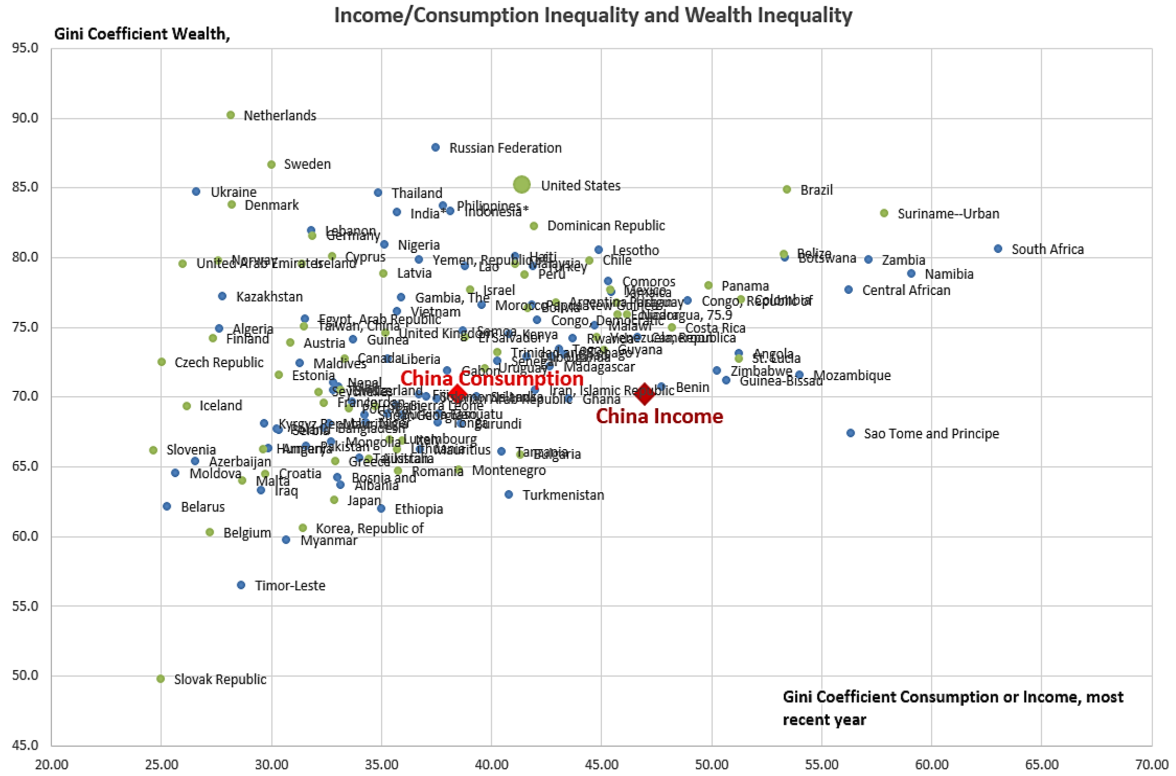
In January 2021 Xi said in a major speech on the topic: "Realizing common prosperity is more than an economic goal. It is a major political issue that bears on our Party's governance foundation. We cannot allow the gap between the rich and the poor to continue growing—for the poor to keep getting poorer while the rich continue growing richer. We cannot permit the wealth gap to become an unbridgeable gulf".

China's policy change comes at a time of declining income inequality over the past decade. According to the World Bank, which uses consumption as a basis, the Gini coefficient, a widely used measure of inequality that varies between 0 (complete equality) and 100 (maximum inequality), peaked at a level of 44 in 2011. Since then it had come down to 38 in 2016, the latest number available.

A level of 38 is comparable to, for instance, Indonesia (Figure 1). China's official measure published by the National Bureau of Statistics, is income based and does not correct for differences in cost of living across China. Its measure for the Gini now stands at some 47, not much lower than the 49 measured at the peak in 2009, but lower nevertheless. The Standardised World Income Inequality Database, which aims to produce internationally comparable data, puts it somewhere between that of the World Bank and the NBS, with a Gini for disposable income of about 40, down from 42 at the peak.

What all indicators agree on is that income inequality is declining. A key driver has been wages, which have been growing faster than GDP (gross domestic product) in the past decade as a result of growing labour scarcity in light of an already declining labour force. In addition, the drive for poverty eradication has upped transfer payments such as rural welfare (or *dibao*), non-contributary rural pensions and free rural education. These are still modest, but they help. In 2016, the income share of the bottom 10% of the population was about 2.7%, up 2% in 2010. In contrast, the top 10% lost income share in the past decade: in 2016 it was 29.4, down from 32.6 in 2010. China's bottom 10% has about the same share of income as Sweden (2.7), Australia (2.8) and Canada (2.7), not exactly countries known for their income inequality. That share is also far higher than that for Brazil (1), South Africa (0.9) and the United States (1.7).

FIGURE 1 INCOME AND WEALTH INEQUALITY



Source: Credit Suisse Wealth Report 2019, World Bank Povcalnet and NBS (for Income Gini).
Note: Blue marker=consumption Gini; Green marker=income Gini

Though it has recently often been cited, "uncontrolled capital" hardly seems to be a cause of income inequalities in China. China's labour share in the economy is, according to the Penn World Tables, about 0.59, which is higher than Japan's 0.56, Korea's 0.51, Norway's 0.52, Sweden's 0.56 and Australia's 0.57, none of them hotbeds of unfettered capitalism. For a developing country, China's labour share is in fact quite high. While it is true that labour shares around the world have been declining in the developed world and leading to tensions on distributions in those countries, it would be hard to argue that China is at that point now, after registering a rise in labour share for a decade from a trough of 51% in 2010.

What about all these billionaires then? Credit Suisse, an investment bank, publishes an annual report on wealth distribution, a much harder measure than income inequality, for sure as wealth is less equally distributed in every country and usually less equal for developing countries. According to this report, in 2019, China's wealth Gini was 70, which was still relatively modest, but higher than some of its egalitarian neighbours such as Japan and Korea, but lower than that for Thailand, India, Brazil and the United States. Indeed, according to Credit Suisse, some countries that are very equal in income distribution are highly unequal in wealth distribution, for example the Netherlands and Sweden.[1] China's 2019 Gini had, remarkably, not deviated much from a decade ago, at 69.

Data aside, the political mood in Beijing has changed. Though inequality has been on the agenda since the Hu-Wen administration—an administration which initiated rural *dibao*, rural pensions and rural health insurance—this time seems to be different. Some see the call for common prosperity as one that adds to the recent regulatory storm on internet companies and

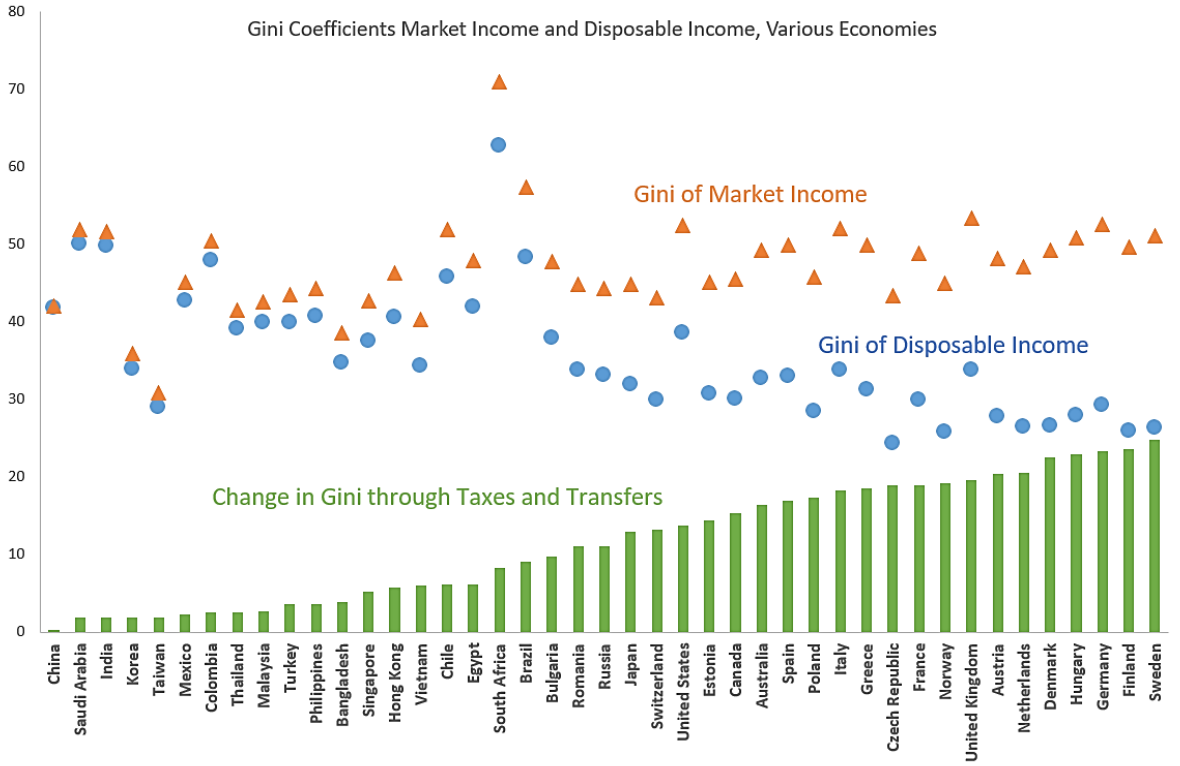
[1] This may reflect the fact that some assets, such as pension wealth, which is very high in the Netherlands, is not reflected in the Credit Suisse numbers.

one that aims at addressing some of the large amount of wealth that these private companies and the individuals who own them have generated. According to some, this is due to the monopolistic practices of those companies, which should be addressed by regulations and otherwise.

So what should government do, if it wants to redress some of the inequalities? Fundamentally, there are two options: redistribute or improve market outcomes.

The first aims for much higher redistribution of market outcomes. This is by and large the route European countries have taken, and to some extent the United States and Japan. Strikingly, these countries all have Gini coefficients of market incomes that are similar or higher than that of China (Figure 2). After redistribution, though, most have Gini coefficients that are well below that of China. They also have much lower growth and are much richer than China. If China is to consider stepping up redistribution through taxes and transfers, it would do well to carefully consider the effects on incentives for workers and entrepreneurs, the drivers for growth in the decades to come.

FIGURE 2 INCOME DISTRIBUTION BEFORE AND AFTER TAXES AND TRANSFERS, VARIOUS ECONOMIES



Source: The Standardised World Income Inequality Database V9.1 Available at https://fsolt.org/swiid/, accessed 24 August 2021.

Nevertheless, there are opportunities for China to increase taxation with limited distortive effects. One is the taxation of capital gains, which are currently untaxed (except for housing). The other is the introduction of an inheritance tax. With the proper level of exemption, both taxes can play a role in ensuring more equal outcomes at manageable administrative complexity. Currently in the United States, there is some debate on introducing a wealth tax. Until the mid-1990s, this was a relatively popular instrument in OECD countries and 12 countries had such a tax. Since then, though, the number has declined to four and most countries have found ways to adjust the income tax in such a manner that the same objectives are achieved.

Remarkably, with all the concerns about income distribution, China's actual income tax takings are rather modest (Table 1). Though the highest rate of income taxation is 48%, comparable to that of OECD countries, the revenues it generates have been modest. Income tax yielded only 1.2% of GDP in China according to IMF data, or only 4% of total revenues. This is far less than the 8.4% of an average OECD country, where personal income tax constitutes some 20% in revenues. In the United States, personal income taxes bring in almost 11% of GDP. Even in India, the yield is 2.3% of GDP.

The fact is that China exempts most from paying personal income tax. The basic exemption is relatively high, which leaves most out of the tax net. The bulk of China's tax revenues comes from VAT and consumption (luxury) taxes and social security contributions. These have a higher burden on the less well-off than on the rich: since relatively poor people spend more of their income on consumption, taxing consumption makes the tax system regressive. Social security contributions have a minimum contribution at the low-income end and a cap at higher incomes, which also makes these taxes regressive (and not just in China).

TABLE 1 REVENUE STRUCTURE VARIOUS COUNTRIES (% OF GDP)

		Taxes on Income and Property									
	Total	Taxes and SS Premia	Personal Income	Corporate Income	Other	Payroll	Property	Goods and Services	Int. Trade	SS Premia	Other
China	28.2	24	1.2	3.8	0	0	0	8.9	0.8	6.5	4.3
Australia	34.1	27.8	11.4	4.7	0	1.4	2.8	5.1	0.9	0	6.3
France	44.7	45.5	8.6	2.1	0	1.6	4.1	9.5	0	16.9	8
Germany	21.3	36.9	9.9	1.7	0	0	1.1	9.1	0	14	7.7
India	47.8	17.7	2.3	3.3	0.9	0	0	9.8	1.4	0	3.6
Italy	47.8	43.1	11.3	2	0.5	0	2.8	8.9	0	13	4.7
Japan	32.7	30.5	5.8	3.9	0	0	2.6	5.3	0.2	12.1	2.1
Korea	21.3	25.2	4.4	3.2	0	0.1	3.1	5.9	0.6	6.7	-3.9
UK	35.8	32.5	9	2.4	0	0	4.1	9.4	0	6	3.3
USA	31.8	26.4	10.7	2.2	0	0	2.7	2.9	0.2	6.2	5.4
OECD Avg.	40.3	33.9	8.4	2.8	0.3	0.4	1.9	9.4	0.1	9	6.3

Source: Courtesy of Andrew Collier, Global Partners, based on IMF data. Note: SS = Social Security

On the transfer side, increasing the payments for rural pensions seems rather harmless—old people usually have little capacity left for work, so there is not much of a disincentive. Current benefit levels are very low (some RMB150-250 per month) and increasing them would improve the income distribution. Increasing *dibao* would also have an immediate effect at little costs. Again, depending on the location, *dibao* benefits are very modest and well below the poverty line. It is perhaps the time to effect a change to the *dibao* system to avoid discouraging workers: currently, a recipient gets a grant that makes up the difference between his or her income and the *dibao* line. This effectively means a 100% tax rate for people with little earning capacity. This can be easily fixed.

The other choice is to ensure that market outcomes become more equal. This is by and large the approach that the economies of Korea and Taiwan have chosen, and, until recently, Japan. Redistribution is far more modest than in the European model, but market outcomes are more equal.

China still has numerous opportunities to achieve more equal market outcomes beyond better market regulation of *all* monopolies (not just the private ones). Investing in education, especially rural education still has high private and public returns. According to the recent census, those with tertiary education constitutes only 18% of China's workforce, compared to 40-60% in OECD countries. The education of rural students is often too inadequate to qualify them for university as Scott Rozelle and others have argued in their book "Invisible China". The large investments made in education after the second world war was a powerful driver of more income inequality.

Second, complete abolition of the household registration system or *hukou* would allow all workers to go where they are most productive, which would increase their wages as well as the labour share in the economy. This requires fiscal reforms that ensure that finance follows people, and reforms in the administration of pension, health and unemployment schemes ensure that mobile workers keep their rights when they move location.

Third, further reforms in rural land management would strengthen farmers' rights on land, and with it the price they can get for the land rights when sold or leased. The reforms at the end of the 1990s granted urban households strong rights of their property that was sold well below market price, and which became exceedingly valuable as reforms and urbanisation progressed. Rural residents missed out on this windfall and most of the rents of rural land conversion accrued to local governments. Changing this would work to equalise wealth in China's economy. It would put further pressure on local government coffers, though, which makes the implementation of the long-awaited property tax even more important.

For now, China seems to opt for a third way, the "Tertiary Distribution". The authorities and opinion makers have been promoting private donations from the rich as a means to redistribute income. China could certainly use more philanthropy: according to the Global Philanthropy Report, spending from philanthropic sources is only US$4.7 billion per year, or less than 0.03% of GDP. However, even the most generous countries, such as Germany (0.7% of GDP) and the Netherlands (0.9% of GDP) spend less than one per cent of GDP. The United States tops the charts in absolute spending at US$80bn or 0.4% of GDP. So while more philanthropy in China is definitely welcomed, it will not make a major dent to income distribution.

Finally, irrespective of which direction policy will take, it is important that this policy is supported by the right analysis. Access to data in income and wealth by policy researchers is critical. Unlike other countries, the NBS does not grant access to its household data and publishes only highly aggregate data. The NBS is understandably concerned about the privacy of the households it depends on for its information, which is a principle anchored in the law. Many countries, though, make anonymised data available to researchers and China could consider doing the same to facilitate decision making based on reality.

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