

Inclusive Growth toward a Harmonious Society in the People's Republic of China: An Overview

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This overview introduces the background of the study “Inclusive Growth toward a Harmonious Society in the People’s Republic of China (PRC)”, under which all the papers in this special volume were prepared. It summarizes key findings of these papers as grouped into three parts: (i) Inclusive Growth and Policy Options; (ii) Balancing Efficiency and Equity Objectives: International Experiences; and (iii) Empirical Analysis of Income Inequalities in the PRC. In concluding, this overview argues that building a harmonious society is the most important development challenge that the PRC faces, and that a development strategy anchored on inclusive growth provides an effective approach to addressing this issue.

I. INTRODUCTION

The economic achievement of the People’s Republic of China (PRC) has been remarkable since it embarked on a reform program toward a market-oriented economy in 1978. During 1979–2006, its per capita gross domestic product (GDP) grew at 8.5 percent on average annually, the fastest in the world. In aggregate terms, the PRC was the fourth largest economy globally in 2005—only after the United States, Japan, and Germany—compared to its 12th rank in 1979. Rapid economic growth has brought significant improvements in the living standards of its people. During the last three decades, average per capita household incomes (including both urban and rural) grew at about 7 percent on average per annum. As a result, poverty incidence has declined dramatically. As reported by the Asian Development Bank (ADB), during 1990–2005, the headcount ratio based on the \$1-a-day poverty threshold declined from 32.5 to 7.1 percent; using the \$2-a-day threshold, it declined from 71.5 to 29.4 percent (ADB 2007b). Such achievements are unparalleled regionally as well as globally.

However, the rapid growth in the PRC has been accompanied by rising income inequalities. In the late 1970s, the country had an overall Gini coefficient of about 0.30; in 2005, the value of this commonly used inequality measure had

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reached about 0.45 (He 2007, Li and Luo 2008, Lin et al. 2008). A prevailing view is that the rising inequalities were caused by increasing income disparities between urban and rural areas and across regions. During 1985–2005, the ratio of urban to rural per capita incomes increased from 1.9 to 3.2, and the ratio of per capita incomes of coastal and western provinces also increased from 1.4 to almost 2 (Zhuang 2008). Even within the same region or same province, income gaps have also increased significantly among urban as well as rural residents. In addition to income inequalities, nonincome inequalities have also increased. The most notable aspect of nonincome inequalities that has attracted a great deal of attention both in and outside the PRC is the access to basic medical services and health care (Tandon and Zhuang 2007).

Rising inequality is an emerging development challenge not only for the PRC. In developing Asia, income inequalities have been rising in many countries since the early 1990s, although in varying degrees. Apart from the PRC, 14 out of 22 developing Asian countries have seen their Gini coefficients rising, most significantly in Bangladesh, Cambodia, India, Lao People's Democratic Republic, Nepal, and Sri Lanka (ADB 2007b). Internationally and regionally, there is a growing concern that the rising inequalities could lead to increasing political and social tensions in many countries, and these pose significant risks to the very sustainability of Asia's growth. Reducing inequalities is therefore considered a major development challenge facing developing Asia today.

Growth and poverty reduction have been the central focus of development policy making in the past in developing Asia. More recently, however, as income inequalities continue to rise, discussions on development policy are paying increasing attention to the issues of equity and how to make growth more inclusive as well. The concept of inclusive growth is increasingly being embraced by developing countries and their development partners including bilateral and multilateral aid agencies. For instance, a panel of eminent persons commissioned by ADB to provide insights on the region's future and how it will affect the future role of ADB called on the institution to expand its strategic objective from poverty reduction to inclusive growth (ADB 2007a).

Recognizing that increasing inequalities could have significant negative social and economic consequences—making reforms more difficult, undermining social cohesion and stability, constraining economic growth, and even derailing the reform process and undermining the country's long term prosperity—the PRC government declared recently the creation of a “harmonious society”, a concept very closely related to inclusive growth. Its 11th Five-Year Plan made the establishment of a harmonious society the basic development goal and top priority. The 17th Chinese Communist Party Congress in October 2007 further elaborated this vision. However, debates among policymakers and researchers have continued on how to reduce income inequalities and how to establish a

harmonious society. Some view rising income inequalities as inevitable and inherent in the economic development process.

Against this background, ADB's Economics and Research Department and East Asia Department jointly carried out a study on "Inclusive Growth toward a Harmonious Society in the People's Republic of China" in early 2007. The purposes of the study were to (i) improve understanding of the characteristics of the PRC's growth process during the last three decades; (ii) examine the challenges facing the PRC arising from increasing inequalities; and (iii) discuss policy options for moving toward a more sustainable and inclusive growth strategy and developing a harmonious society. Under the study, eight papers were prepared by scholars from the PRC and ADB staff. These papers were discussed at a finalization workshop on 9 August 2007 in Beijing, attended by more than 100 participants from domestic research institutes, think tanks, universities, government agencies, and international organizations. This special issue is a compilation of these papers.

This special issue comprises eight papers grouped into three different but related parts. The first part discusses conceptual issues of inclusive growth and policy options for the PRC in its endeavor to develop a harmonious society. The second part draws lessons for the PRC from the experience of East Asia in addressing the equity issue in the growth and economic development processes. The third part provides empirical analysis of income inequalities in the PRC and their causal factors.

II. KEY FINDINGS AND POLICY RECOMMENDATIONS

A. Inclusive Growth and Policy Options

The first paper by Ifzal Ali (Ali 2008) describes recent trends in income and nonincome inequality in developing Asia. Although globally the Gini coefficients of developing Asian countries are not particularly high, worsening income distribution is a major concern. This is because moderate levels of income inequality can coexist with high levels of inequality in areas that are essential for human well-being. Further, low levels of income inequality can also coexist with high levels of inequality in asset ownership and access to infrastructure services. More generally, household wealth—essentially ownership of physical and financial assets—tends to be unambiguously more unequally distributed than incomes or expenditures. Concentration of wealth or assets implies that potential economic opportunities can be difficult for the economically disadvantaged to seize. Similarly, when public infrastructure is distributed very unequally across a country, a great proportion of the population in lagging subnational regions in developing Asia have no access to electricity, sanitation, or clean water.

The paper argues that while reduction in poverty incidence has been very significant in many developing Asian countries, increases in inequality in recent years have dampened the poverty reducing impact of growth. In the PRC, for example, if inequality had not worsened, poverty incidence would have been 5.7 percentage points lower in 2004.

Ali also discusses how rising inequality will impact on a country's long term economic growth. In terms of "wealth effects", the underlying factor linking high inequality with lower growth is the idea that tomorrow's wealth or incomes depend on today's. People with little wealth or low incomes are unable to invest in wealth- or income-enhancing activities and, thus, remain poor. What is of interest as suggested by this line of argument is that redistribution of assets, far from having adverse distortionary effects, will be growth-enhancing. In terms of political economy considerations, one class of arguments links higher inequality with the pressure to redistribute. Redistribution lowers growth if it is executed through transfers that are distortionary. For example, redistribution that is financed by a tax on capital will reduce investment and growth. Likewise, the process of bargaining that accompanies the call for redistribution, ranging from peaceful but prolonged street demonstrations all the way to violent civil war, may be costly. Another class of political economy arguments works through the adverse effects of inequality on the quality of institutions and/or policies. If high levels of inequality give high-income individuals greater ability to tilt economic outcomes and policies in their favor, growth prospects may well diminish.

Ali finally looks at the role of public policy in responding to rising inequality. In the design of public policy, it is useful to consider whether the inequalities or increases in inequalities are driven by differences in effort or by differences in circumstances outside the control of individuals. While it would be unfair to hold individuals responsible for the circumstances they find themselves in, they may be held responsible for their efforts. Public policy must, on one hand, focus on creating productive employment opportunities and, on the other hand, ensure equal access to these opportunities. Clearly, even when public policy ensures equality of opportunity, inequality as an outcome could arise from different levels of effort, risk taking, and entrepreneurship.

Ali concludes that Asia's success in addressing extreme poverty in the last two decades is laudable. With prudent policies for growth and distribution, extreme poverty will be largely eradicated by 2020. However, rising income and nonincome inequalities are making it very important to shift the focus to increasing opportunities for all. In particular, in addition to about 500 million workers who are underemployed, the Asian demographics suggest that over 300 million new entrants will join the job market by 2020. To find decent and productive jobs for the underemployed and to reap the benefits of the demographic dividend, inclusive growth will need to be ensured. This will entail

generating opportunities from economic growth on a massive scale, and sharing these opportunities equitably.

Juzhong Zhuang (Zhuang 2008) outlines a conceptual framework for a development strategy anchored on inclusive growth. Defining inclusive growth as “growth with equal access to opportunities for all members of a society”, the framework differentiates inequalities due to individual circumstances from those due to individual efforts. Individual circumstances refer to factors outside the control of individuals such as family and ethnic background, social relations, gender and geographical locations. It is argued that inequalities due to such factors often reflect social exclusion arising from institutional weaknesses, market failures, or policy shortcomings. While an individual's efforts represent actions that are under the control of the individual, inequalities due to differences in efforts reflect and reinforce market-based incentives needed to foster entrepreneurship, innovation, and growth. This differentiation leads to an important distinction between “inequalities in outcomes” and “inequalities in access to opportunities.” Inequalities in access to opportunities are mostly due to differences in individual circumstances, while inequalities in outcomes such as incomes reflect some combination of differences in efforts and in circumstances.

Zhuang argues that promoting equal access to opportunities, which emphasizes eliminating circumstance-related inequalities, is at the core of inclusiveness and of an inclusive growth strategy. An inclusive growth strategy is thus anchored on two pillars: one is to create economic opportunities through high, efficient, and sustainable growth; and the other is to broaden access to opportunities by all members of a society by promoting social inclusion. It is argued that promoting social inclusion requires public interventions in three areas: (i) investing in education, health, and other basic social services to expand human capacities especially of the disadvantaged; (ii) promoting good policy and sound institutions to advance social and economic justice and level playing fields; and (iii) developing or improving social safety nets to prevent extreme deprivation.

Zhuang contends that a development strategy anchored on inclusive growth provides an effective avenue toward a harmonious society in the PRC. On one hand, a harmonious society will have to be based on high and sustainable economic growth—the first pillar of an inclusive growth strategy. Only through growth can productive and decent employment and other development opportunities be created. On the other hand, years of experience have shown that rapid growth alone cannot guarantee equitable access to opportunities. Developing a harmonious society requires broadening the access to opportunities by all members of a society by promoting social inclusion—the second pillar of an inclusive growth strategy.

Zhuang argues that adopting a development strategy anchored on inclusive growth requires continued policy and institutional reforms to keep growth high

and sustainable. While continuing its integration with the rest of the world, the PRC needs to pay greater attention to domestic economic and market integration. This will provide new sources of growth, which will in turn generate new employment opportunities while effectively reducing income disparities between urban and rural populations and across regions. Deepening domestic integration, however, should rely mainly on the private sector and be driven by market forces. The role of the government is to address market, institutional, and policy failures and weaknesses so as to eliminate various distortions and barriers.

Zhuang further argues that a carefully designed redistributive policy is an important element of an inclusive growth strategy. However, the purpose of redistribution is not simply to equalize income but to promote equal access to opportunities so as to improve income distribution. The PRC government has exerted significant efforts by adopting public policies aimed at improving equalization of opportunities, such as increasing investment in infrastructure in western regions, increasing investment in basic education and basic health care, speeding up the development of the new rural society, and developing and improving social protection systems. The PRC government needs to continue these measures and make them more effective.

Finally, an inclusive growth strategy requires further strengthening governance and institutions, promoting economic and social justice, leveling playing fields, and preventing corruption. Zhuang argues that for future policy choices, it is important for the PRC to avoid two tendencies: one, to only focus on economic growth while ignoring the inclusiveness of growth; two, to rely excessively on redistributive policies in order to achieve equalization of incomes.

In support of the first pillar of an inclusive growth strategy, Justin Yifu Lin and Peilin Liu (Lin and Liu 2008) argue that by developing industries where the PRC has comparative advantage, namely, labor-intensive industries and labor-intensive segments of capital-intensive industries, the PRC can achieve the twin objectives of efficiency and equity simultaneously at the primary income distribution stage. They therefore challenge a popular view in the PRC that the primary income distribution stage should aim to achieve the efficiency objective while the secondary income distribution stage (through redistributive mechanisms such as taxation and transfers) should aim to achieve the equity objective.

Lin and Liu compare the so-called comparative-advantage-following (CAF) strategy with the comparative-advantage-defying (CAD) strategy. Adopting the CAF strategy would lead to improved efficiency as (i) enterprises could take full advantage of abundant labor, minimize production cost, enjoy competitive edges without government protection, and maintain rapid and sustainable growth; and (ii) the economy could achieve the highest possible pace of capital accumulation, structural changes, and technological progress. Further, the CAF strategy would help generate the maximum possible amount of job opportunities, reduce the dualistic nature of the economy, and enable low-income

segments of rural and urban populations—whose main means of earnings is labor—to share the fruits of growth. More jobs and higher wage earnings would ultimately reduce the income gaps between ordinary workers and “rich” people, leading to improved equity.

Through regression analysis, the authors tested the impact of the choice of development strategy on growth in the context of the PRC. A province's choice of development strategy was represented by the technology choice index, which measures the deviation of the capital-labor ratio of its manufacturing industry from the capital-labor ratio of the entire province's endowments. The results strongly support their hypothesis: a province adopting the CAD strategy has a lower growth rate of per capita GDP than a province adopting the CAF strategy.

Lin and Liu argue that over the next 15 years or so, the PRC will remain a middle-income country, with labor relatively abundant and capital scarce. Taking advantage of factor endowments, the PRC was able to achieve rapid economic growth through developing small and medium enterprises (SMEs) in labor-intensive industries and labor-intensive segments of capital-intensive industries. However, due to the incomplete economic transition, there remain significant market and institutional distortions in the economy. These distortions hinder the further transition from a traditional development strategy—focusing more on the speed of growth than on its efficiency—to a CAF-type strategy, leading to widening income gaps between urban and rural areas and across regions.

Lin and Liu provide a number of policy recommendations for adopting a CAF strategy. The first is to promote the development of labor-intensive SMEs in the manufacturing and services sectors by facilitating credit access and market entry. The second is to deepen the reform of large state-owned enterprises (SOEs). Eliminating the remaining administrative protections of the SOEs inherited from the planning era—which include artificially keeping the prices of capital, natural resources, and other inputs low; and allowing the SOEs to maintain monopolistic positions—would help reduce the scope of rent-seeking and prevent corruption. The third is to introduce and promote competition, and strengthen regulation as appropriate, such as in the electricity industry. The last is to rationalize the incentive structure of local government officials so they would not pursue short-run gains in the pace of growth at the cost of long-run efficiency.

Mai Lu and Mingliang Feng (Lu and Feng 2008) look at policy options for establishing a harmonious society in the PRC from the perspective of broadening the access to development opportunities—the second pillar of the inclusive growth strategy. The key question they ask is how to reform the PRC's welfare system to ensure adequate investment in education, health, and basic social services; and to provide effective social safety nets. The PRC started reforming its welfare system in the early 1990s. However, substantial progress has been made only since the late 1990s in response to the deepening of the reform process and increasing income inequality. Although the level of welfare provision is still

low, the coverage is wide and expanding, and the burden on the state is increasing. The PRC government's basic objective in reforming the welfare system is to provide social safety nets and help low-income groups, rather than attempt to redistribute and equalize incomes. Increasingly, attention is also being devoted to investing in human resources.

Lu and Feng describe the progress in reforming the PRC's welfare system, particularly in the areas of education, medical care, employment support, pension, and poverty relief. They cite several recent measures targeted at the rural population, such as extending the coverage of the free 9-year compulsory education to all rural children, and introducing the minimum social security system to the rural population. Despite the progress, the PRC still has a long way to go in further reforming its welfare system conducive to the formation of a harmonious society.

The authors propose three areas of reform priorities. The first is to further reduce the dualistic nature of the PRC's welfare system. Despite recent reform efforts, the welfare system still differentiates between urban and rural areas in terms of policies, institutional arrangements, coverage, and welfare provisions. They argue that this dual structure has contributed to the widening of the income gap between urban and rural populations. The dual structure is also making rural migrant workers, numbering about 140 million and who are not covered by the system, an underprivileged community extremely vulnerable to various economic and health shocks. Extending the uniform welfare coverage to migrant workers requires more investment in basic infrastructure such as schools, transport, and housing in cities. This would in turn require increased budgetary allocations from both the central and provincial governments to supplement municipal government resources.

The second area of reform is to further rationalize government social security and welfare expenditure. As the PRC's economy rapidly expands, government revenues have also grown strongly. The PRC government needs to further strengthen its budgetary management system to make it fairer, more efficient, and transparent. Consolidating all revenue sources to include extra-budgetary revenues and "extra-system revenues", government revenues in 2006 could have reached about 32 percent of gross domestic product. The PRC government also needs to promote greater public participation in budgetary allocations for social programs to ensure better alignment with the needs of the people. Reforming the welfare system would also require improving the structure of public spending through rationalized government investment in economic construction activities and controlling spending on administrative overhead. With strong public finance and better management, the government would be in a better position to release more resources for social welfare programs.

The third reform area is to rationalize the overall management of the welfare system, guided by three priorities: (i) reform the existing

compartmentalized government administration of urban cities and rural areas toward a unified welfare system providing uniform coverage for urban and rural populations; (ii) encourage better coordination among various government agencies involved in policy making and administration of the welfare system to improve performance and efficiency; and (iii) make the targeting of poverty reduction and social welfare programs more effective.

Min Tang (Tang 2008) explores policy options that will strengthen the PRC's poverty reduction efforts and position the PRC's future growth on a more inclusive footing. The PRC's poverty reduction endeavors have registered remarkable progress, but much remains to be done if poverty is to be attacked at its roots in the current development context. In the process of establishing a harmonious society, the PRC can now afford to devote more resources to poverty reduction than before. However, as the PRC remains a developing nation, it has to adopt a gradualist approach in formulating its antipoverty strategic objectives and policies.

Tang offers the following policy options/measures to further poverty reduction efforts in the PRC:

- (i) The PRC should modify its poverty threshold, which was established in the 1980s, to make it compatible with the country's current level of economic and social development. The use of the development poverty threshold, estimated for 2005 at CNY1,147 per capita by the China Development Research Foundation, is supported.
- (ii) The PRC should encourage financial sector participation in poverty reduction. To develop rural finance, it is imperative to allow microfinance institutions and other rural financial institutions to establish their presence in the countryside and be granted legal status.
- (iii) More equitable access to education should be provided so as to prevent poverty from being transmitted across generations.
- (iv) Access to medical services in rural areas should be improved so as to alleviate poverty caused by illnesses.
- (v) The social security system and system of public services in rural and urban areas should be improved.
- (vi) A sound public finance mechanism for poverty reduction and improving governance in antipoverty efforts should be put in place.
- (vii) The PRC should encourage the participation of nongovernment organizations (NGOs) in poverty alleviation. To make the utilization of government funds for poverty reduction more efficient, it is imperative to explore ways to introduce competition

over the use of poverty alleviation resources so that more NGOs will become the operators of government-funded poverty reduction programs. For their part, NGOs should keep improving their organizational structure and capacity to work effectively.

B. Balancing Efficiency and Equity Objectives: International Experiences

International experiences in addressing the equity issue in economic growth processes provide valuable lessons in devising policies and strategies for building a harmonious society in the PRC. Shi Li and Chuliang Luo (Li and Luo 2008) look at the development experience of East Asian countries, particularly Republic of Korea and Taipei, China. They note that, according to standard economic theory, either in the form of the well-known Kuznets's inverted U-curve hypothesis or the Lewis model of a dual economy, income gaps tend to widen at the initial stage of economic development. However, empirical studies since the 1980s have failed to convincingly verify such a relationship between income inequality and the level of development.

Japan; Republic of Korea; and Taipei, China are widely considered as good examples of having avoided the widening of income gaps in the process of economic growth. Li and Luo argue that a major reason why these economies were able to avoid the widening of income gaps at their early stage of development was the particular growth pattern they chose. Their chosen path gave a large segment of the population the opportunities to share the outcomes of economic growth. This growth pattern can be split into two stages. At the first stage, rigorous efforts were made to promote the development of labor-intensive industries, especially in the manufacturing sector. By increasing manufacturing employment, absorbing agricultural surplus labor, and reducing rural unemployment, the proportion of wage incomes in national income rises, which to some degree reduces income gaps. At the second stage, the growth of the service industry also becomes a major growth engine. In the absence of surplus labor, growth leads to wage rate increases in the manufacturing sector and narrows down the wage rate differentials among different sectors, thus narrowing income gaps in the whole economy.

Li and Luo contend that the PRC has a lot to learn from the development experiences of these economies. First, the PRC should choose a growth pattern conducive to job creation by developing labor-intensive industries and enterprises. This reinforces the recommendation by Justin Yifu Lin and Peilin Liu (Lin and Liu 2008) to adopt a CAF-type development strategy. Despite 30 years of rapid growth, the PRC still faces enormous pressures to create jobs and absorb large numbers of rural surplus labor and urban laid-off and unemployed people. Second, shifting from a capital-intensive growth pattern to a labor-intensive growth pattern requires developing more SMEs, as what Republic of Korea and

Taipei, China did at their earlier stage of development. Third, developing labor-intensive industries and SMEs requires the PRC to reduce the role of the government in productive investments and to promote private investments, by eliminating restrictions in market entry and credit access. Fourth, a labor-intensive growth pattern needs to be supported by an efficient financial system. Improving access to credit by SMEs requires developing more small- and medium-size banks and nongovernmental financial institutions. Finally, the PRC needs to develop a unified labor market and to eliminate the institutional factors that obstruct the free flow of labor and capital.

C. Empirical Analysis of Income Inequalities in the PRC

The last two papers provide empirical analysis of income inequality in the PRC. In the first paper, Tun Lin, Juzhong Zhuang, Damaris Yarcia, and Feng Lin (Lin et al. 2008) examine the evolving trend of income inequality and its determinants in the PRC during 1990–2004. The paper uses unit-level data extrapolated from grouped income data of 23 provinces covering both rural and urban households representing more than 85 percent of the population. The results show that the national Gini coefficient of per capita income increased from 0.345 in 1990 to 0.456 in 2004. But adjusting for differences in the cost of living (COL) across regions and between urban and rural areas, the Gini coefficient increased only from 0.287 to 0.387, suggesting that not adjusting for COL differences could overestimate the Gini coefficient by 20 percent. Income inequality increased in both urban and rural areas, but urban inequality increased at a faster pace. Across regions, the coastal, central, and western regions all experienced increases in income inequality and, in 2004, inequality was the highest in the western region, followed by the coastal and central regions. Across provinces, income distribution was constantly more unequal in Guangdong, Qinghai, Shaanxi, and Xinjiang.

Decomposing national inequality into between and within urban and rural areas using the Theil index, Lin et al. find that rising inequalities between urban and rural areas and within the urban area were the major sources of the increases in national inequality. In 1990, after adjusting for COL differences, the between urban–rural inequality and within-urban inequality accounted for 12 and 16 percent, respectively, of the national inequality; in 2004, the contribution increased to 30 percent for the former and 34 percent for the latter. The within-rural inequality also increased, but at a slower pace, and hence its contribution declined from 72 percent in 1990 to 36 percent in 2004.

Decomposing national inequality into between-region (i.e., inequality between the coastal, central, and western regions) and within-region components, the paper finds that the between-region inequality contributed little to national inequality: 10 percent in the case of nominal incomes and less than 4 percent after

adjusting for COL differences, in 2004. This is in sharp contrast to the common perception that rising regional inequality is one of the key drivers of inequality at the national level in the PRC. Decomposing national inequality into between-province and within-province components, it is found that the within-province inequality was the major source of national inequality. After adjusting for COL differences, the contribution of the within-province inequality increased from 86 percent in 1990 to 89 percent in 2004; while the contribution of the between-province inequality declined from 14 to 11 percent, further showing that rising regional inequality was not a major driver of the increases in national inequality in the PRC.

On the basis of these findings, Lin et al. argue that the most effective ways of reducing overall inequality in the PRC are to narrow the income gap between urban and rural areas and to reduce income inequality among the urban population. Regional income disparity (between coastal and western regions and among rich and poor provinces) remains large and needs to be reduced, but the impact of this reduction on inequality at the national level may be limited. Nevertheless, reducing regional income disparity is very important for poverty reduction, because the majority of the poor population in the PRC is located in the western region.

The last paper by Minquan Liu and Jiantuo Liu (Liu and Liu 2008) argues that the PRC's financial structure is one of the critical factors contributing to the widening rural–urban inequality. By improving the PRC's financial structure toward supporting the development of SMEs, more off-farm employment opportunities can be generated, and thus help close the urban–rural income gap. The development of SMEs helps improve income distribution in the PRC for at least two reasons. First, SMEs are more labor-intensive than large firms, and hence can generate more employment opportunities. Second, SMEs help improve access to markets by dispersed rural households. Better access to markets increases the value-added of farm products, enhances rural incomes, and reduces income disparity among regions and between urban and rural areas. Liu and Liu find that in rural areas, most SMEs consist of township and village enterprises (TVEs). In the past 30 years, TVEs have accommodated a significant number of rural households to shift from farming to off-farm employment. Off-farm wage incomes surpassed farm incomes and became the most important source of income for rural households in 2005. The paper thus claims that promoting the development of SMEs and TVEs is both necessary and viable.

The paper then discusses how the structure of the PRC's financial system has hindered the development of SMEs. The PRC's banking sector is highly concentrated and dominated by state-owned large banks. Such a structure reduces SMEs' ability to obtain funding and thus impedes the development of SMEs, hence contributing to urban–rural and regional income inequalities.

Liu and Liu present the following policy recommendations:

- (i) Actively develop small- and medium-size financial institutions, encourage financial market competition, and allow disadvantaged groups to participate in the financial markets.
- (ii) Establish investment regulations at the community level, balance resource distribution, and ensure flow of funds toward rural areas and western and central regions of the PRC.
- (iii) Improve the infrastructure of financial markets, especially of the credit system, and establish laws and regulations for financing SMEs, making policies supportive of SMEs.
- (iv) Simultaneously, encourage the development of informal financial institutions that are particularly useful to SMEs.

III. CONCLUDING REMARKS

How to build a harmonious society is the most important development issue the PRC faces at present and in the coming years. This special issue brings together results of and findings from a number of studies undertaken by prominent economists and experts in the PRC and by ADB staff members, with a view to generating more debate and discussions and leading to more extensive analysis and in-depth research.

The main conclusion of these studies is that a development strategy anchored on inclusive growth provides an effective route to building a harmonious society in the PRC. On one hand, building a harmonious society requires high, efficient, and sustainable economic growth; only through such growth can large amounts of employment opportunities be created. On the other hand, building a harmonious society also requires the elimination of various inequalities in access to opportunities, so as to improve the inclusiveness of growth. To sustain efficient and high growth, the PRC needs to promote the development of labor-intensive industries and labor-intensive segments of capital-intensive industries, thereby achieving efficiency and equity simultaneously in the primary income distribution stage. To promote equal access to opportunities, the PRC needs to ensure adequate investment in education, health care, and other basic social services; establish an effective and unified social security system for both urban and rural populations; and further strengthen governance and institutions, promote economic and social justice, level playing fields, and prevent corruption.

Finally, for future policy choices, it is important for the PRC to avoid two tendencies: one, to only focus on economic growth while ignoring the inclusiveness of growth; two, to rely excessively on redistributive policies in order to achieve equalization of incomes. International experiences show that

both of these two policies are not conducive to efficient and sustainable social and economic development.

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