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Policy Implications of China's Regional Inequality

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Abstract: China has experienced a rapid economic growth in three decades as a result of market-oriented reforms. However, regional inequality in China has also shown a tendency to increase over the past three decades. Though often overlooked in analyses of China's rapid economic growth in recent years, the existing literature suggests that ensuring the benefits of growth shared equally is a key component of social and political cohesion. This study explores the policy implications of regional inequality in China concerning historical review and policy recommendation. The main findings of this study to address the regional inequality are two points: first, new policies should provide more business chances for the inland region, in particular, government should set new SEZs (Special Economic Zones) in central and west in order to link the regions together sharing the benefits of economic reform; moreover, through the reform of SOEs (State-owned enterprises), the country should let private sectors gain more incentives and dynamic to boost the efficiency of economic development especially interior areas.

Key words: Regional inequality, China, historical review, policy implication

INTRODUCTION

China's social and economic stability is facing a great challenge due to rising regional inequality. Central government is aware that it is necessary to deal with this issue to prevent the flow of labour, capital and other resources from the poor interior regions to the wealthy eastern areas; and from the rural areas to the urban areas. Without policy intervention the disparity is liable to increase further. Therefore, in order to achieve balanced economic growth and a harmonious society, China's regional development policy must shift from emphasizing growth to prioritizing equality. This change will be beneficial to development in the long run, because, as it is at present, the increasing disparity will adversely affect China's long-term growth (Zhu and Wan, 2012). Furthermore, policies aimed at prioritizing equality should not only focus on increasing economic income in inland areas, but they also need to focus on developing education, healthcare and social security in less developed regions. The studies examined in will discuss about the policy implications of regional inequality for government policy making.

Brief historical review of government policy concerning regional inequality: From the beginning of the 1990s, the Chinese government has been increasingly concerned with the unbalanced nature of regional development. In

fact, central government has never ignored the issue of the disparity between coastal and inland development. As the research referred to above has shown, during the 1980s when development strategy heavily favoured the eastern areas, however some policies were also instituted to tackle the problem of coastal-interior gap (Wei, 2002). Due to these policies, certain special funds, tax exemptions and preferential bank loans have been continuously granted to the under-developed inland areas. Furthermore, the open door policy and the reform of the economic structure have been gradually extended to the central area of China. Coastal provinces were encouraged by government to make compensation agreements on raw materials and energy procurement with the western provinces. With the growth of GDP, the state began to invest increasingly in the inland regions from the middle of the 1990s onwards with particular focus on energy and raw materials. Through this the interior has experienced some growth during this period but these effects have not achieved a great deal in terms of reducing the gap between regions and there is still much room for improvement.

In large part as a response to the widening regional inequality, the central government initiated a "Western Development Strategy (Go West)" to combat worsening regional inequality. Between 2000 and 2005, the central government started 70 main construction projects and the total amount of investment in the western regions reached

one trillion Yuan. More than one third of the funds raised by long-term government bonds for construction were directed to the western regions during this period and from 2002 to 2005 the percent of funds from these bonds directed to the region reached 40%. From 2000 to 2005, the new roads built in the western region reached 220,000 km, with 6,853 km of highways. By 2005, the central government invested 460 billion Yuan in construction projects in the western areas. Fiscal transfers and subsidies of 500 billion Yuan were also invested in the western areas.

What is more, in response to this widening inequality, in 2005 the Chinese government adopted an explicit objective of “harmonious development”¹. A key dimension of harmonious development is balanced development across regions. Many strategies and investment plans have been developed to stimulate growth and improvement of living standards of residents in rural areas and in less developed Western China.

Moreover, since January of 2006, the government has fully abolished agricultural taxation, for the first time in over two thousand years of Chinese history. The government also provided subsidies to grain producers to boost agricultural production and farmer income. Furthermore, the government has gradually waived various fees for basic education in rural areas and in the past several years, a new rural collective medical scheme has been introduced.

Central government tried to encourage coastal enterprises and foreign investors to provide capital and management skills to improve development conditions in interior areas. Conversely, it is also important to open up the interior provinces to attract more investment and international trade. As well as funding and allocating more resources to impoverished areas, these funds also need to be used more efficiently to support other aspects of society. Whilst it is necessary that some funds be invested in short-term poverty reduction, the majority needs to be invested in long-term projects concerned with issues such as education, healthcare and social security. These factors play a significant role in reducing the disparity between regions and creating a basis for more sustainable and balanced development. Investment in other projects such as micro-finance ventures, improved transport and telecommunications would also yield positive results in terms of resolving the disparities in opportunity, development and economic security.

Another issue that is important to address when introducing policies aimed at reducing regional inequality

is the free movement of labour between different regions and the provision of adequate living conditions for migrant workers.

Only when the government in China is seriously dealing with all aspects of inequality can the issue be significantly improved and a sustainable basis for growth be developed. Going forward, the government has expressed a clear objective of “harmonious development,” which includes addressing regional disparities. On the basis of the historical experience in China, as well as international experience, we now consider a number of policy instruments to achieve greater regional equality, in the section below, I discuss the implications of the above analysis for policies aimed at tackling regional inequality in China.

The following policy implications are divided into several aspects (governance reform, infrastructure investment, FDI, the financial market and fiscal reform, reform of state owned enterprises, job creation) is concerned boosting efficiency of economic activities in inland areas,

POLICY IMPLICATIONS

Governance reform: Apart from the above traditional policies, China has also tried many more heterodox policy measures to help the lagging areas. For example, the pair-wise province-to-city aid strategy created by the central government after the Sichuan earthquake in 2008. Each city in the earthquake region was paired with an unaffected province, usually in a more developed coastal region. The province took full responsibility for the recovery and reconstruction in the designated county. The province government in the coastal region was evaluated based on their performance in terms of recovery and reconstruction in their assigned corresponding county.

For another experiment, in the planning economy era, the evaluation of cadres was based primarily on political performance. Since the economic reform started in the late 1970s, political conformity has been replaced by yardstick competition in key economic indicators and central mandates, such as GDP growth rate, fiscal revenue growth rates and family planning (Li and Wei, 2010). Since these indicators have been written into local leaders’ contracts, the contents of the contract influence the behavior of local offices. The impact of a physical infrastructure can be easily observed right after it is built while it takes a much longer time, often beyond the four year term of a

¹Harmonious development is a socio-economic vision which aims for a “basically well-off” middle-class oriented society. First proposed by the Chinese government under the Hu-Wen Administration during the 2005 National People’s Congress, the idea changes China’s focus from economic growth to overall societal balance and harmony.

county director or province governor, to witness the lasting impact of a social investment. The central government has adopted a reform to improve the evaluation indicators for local officials. In some areas, the social indicators have been included in cadres' contracts in a bid to encourage them to care more about social development. However, simply including more social indicators may not work because of the challenges in monitoring and evaluating social indicators. Recently, some regions have tried to reward local officers to stay in his post for more than two terms at a higher pay scale. The purpose of longer tenure is to align local cadres' incentives with a more balanced long-term development goal. In the meantime, some intermediate outcomes or process variables can also be introduced, for example, citizen report cards, spending on education and health and enrollment rates, to evaluate the annual performance of government officials. This new progress will significantly contribute to the development in the western area, since the lagging area need long-term development strategy and continued policy to enhance the basement of development.

Overall, institutional reform and innovation in regional governance is identified as a key policy response to regional inequality. However, the particular reform measures can be heterodox and context specific. Some experiments are already under way. We have suggested some more in this section. Such an experimental approach and learning from the lessons of the eastern experience, appears to us a more fruitful route in this area than looking to other countries for experiences with governance.

Infrastructure investment: Recent studies on China have shown that investment gap in public infrastructure can be both an explanation for regional inequality and, therefore, part of a strategy for containing rising regional inequality. Ravallion (2005) establishes that there are indeed spatial agglomeration forces at play in explaining changes in individual level incomes and the crucial role of local infrastructure (as well as local natural endowments) in explaining successful income growth. Using the agricultural census data in 1998, Fan and Zhang (2004) show that rural infrastructure and education play an important role in explaining the large spatial difference in rural nonfarm productivity. Using detailed road data by type, Fan and Connie (2008) further confirm that investment in rural roads even have higher returns than investment in highways. Fan and Zhang (2004) develop a comprehensive analysis of the role of different types of government expenditure on rural growth and poverty. Using a wide range of provincial data over a period of a

quarter century, it builds and estimates a simultaneous equations econometric model to calculate economic returns, poverty reduction and impact on regional inequality of different categories of public expenditure. It is shown that productivity is enhanced and poverty is reduced by increased expenditures for research and development, irrigation, education, roads, electricity and telecommunications. The policy implications of this analysis are direct and strong. If the government wishes to manage growing regional inequality in China, then investing in public infrastructure in the lagging regions will have to be an important policy priority.

In the past several years under "the Western Development Strategy" and the new socialism countryside movement, the government has made significant strides in investing in infrastructure, particularly through improvements of roads and railways in lagging regions. Overall regional inequality has leveled off and even slightly declined since the mid 2000s, a few years after the western development strategy took place (Fan *et al.*, 2012). This provides some tentative evidence that the western development strategy may have played a role. The demand for labor is also overtaking supply, creating a labor shortage in the past several years (Zhang and Zhou, 2012).

There is an increasing pressure for firms to outsource production or relocate their business to the inland regions to access more abundant land and cheaper labor. Improvement in road networks enables many previously inaccessible interior regions to receive outsourcing orders from coastal production centers. The rapid industrialization of the coastal regions is largely due to a successful cluster-based production model. A basic feature of cluster-based rural industrialization in the coastal region is the deep involvement of local governments, particularly township governments. At the initial stage when private ownership was officially recognized by the Chinese constitution, local governments provided de facto protection of private property rights (Xing *et al.*, 2009). Later on, township governments took strategic responsibilities for the overall development of industrial clusters. Therefore, it is also important to nurture cluster development in lagging regions. Some of the successful clustering experiences in the coastal regions may be relevant to the interior regions.

Chinese authorities have responded to the growing regional gaps by increasing infrastructure investment in the lagging regions. There is sufficient experience in China to learn from on this front. Research shows that the returns to infrastructure investment in lagging regions are in general increasing. However, there are two specific

issues on which more detailed research is needed: (1) Further analysis on what specific types of infrastructure have the highest returns in which specific regions and (2) The problem of very remote regions. In these regions, the marginal returns to infrastructure investment may decrease quickly as it can become extremely costly to build roads and other types of infrastructure-for these regions, a more feasible option may be to move people out of the fragile lands into areas with more jobs.

Financial market and fiscal reform: The development of the financial market plays an important role in resolving the issue of regional inequality in China, especially in the interior regions. Equalization of domestic capital across country would cut regional disparity by 20% (Zhu and Wan, 2012). In order to narrow the gaps in capital possession, it is necessary to break the vicious circle in capital formation (Zhu and Wan, 2012). Particularly, the government needs to invest more in the lagging regions in terms of bank loans and tax concessions. Especially, the financial institutions should lift some of the restrictions on concessions and loans to aid small farmers and rural activities (Wan *et al.*, 2007).

In addition, the collection and allocation of fiscal resources need to be changed, since the fiscal policies have favoured the developed regions for a long time. According to Zhu and Wan (2012) the equalization of fiscal support may lead to about a 15% decrease in regional disparity (Zhu and Wan, 2012). The fiscal support needs to be concentrated on education, health care and infrastructure in the lagging areas and also to develop an effective mechanism for risk-sharing in impoverished area to maintain macro-economic stability in these areas (Zhang and Zhou, 2012).

Reform of state owned enterprises: The reform of State Owned Enterprises (SOEs) is also an important issue to consider in relation to policies focussed on reducing inequalities. They still account for a large part of economic activity in China and restructuring of SOEs may generate a huge amount of redundant workers, creating a serious problem in terms of re-employment. Since the rich coastal areas have the majority of private sector enterprises, as well as the financial resources to support restructuring and privatization, reform of SOEs there is likely to be easier than inland. In the lagging regions, it is liable to be a big challenge accompanied by great unemployment. This in turn is liable to increase regional disparity in the future and needs more proper policies to deal with.

Foreign direct investment: Foreign Direct Investment (FDI) plays an essential role in economic growth but uneven distribution of FDI can easily exacerbate regional inequality. Further globalization is liable to widen the regional gap in China if the policy still favours the coastal regions. Poor regions do not share the same advantage as the coastal areas in terms of infrastructure, market potential and location considerations. The government should try to promote trade and FDI flows to west and central China and also help these regions to attract FDI and promote trade themselves. Moreover, while FDI should still be encouraged generally, it is better that it goes directly to the western and central areas instead of getting absorbed by the rich coastal regions. Therefore, government intervention and preferential policies are necessary to create a superb environment for absorbing FDI in inland China (Wei *et al.*, 2009). In particular, policy initiatives are crucial in building the “soft environment” that will facilitate this and not just focusing on the modern infrastructure building (Zhu and Wan, 2012).

Job creation: Job creation is another important consideration for policies aimed at narrowing the income gap as labour is always the sole resource of impoverished families while affluent people generally own capital and other resources (Zhang, 2006). In order to create more jobs, China needs to promote the development of the labour intensive industry, which can absorb a large labour force. According to recent research, the present service industry contributes roughly 40% to the whole GDP of China and it accounts for approximately 35% of the employment rate in the country (Zhu and Wan, 2012). However, both portions are still low compared with developed countries. Most of the countries in the OECD group have service sectors that account for over 50% of national GDP and over 60% of the employment. For China, this level would mean 400-456 million jobs in the service industry, while the present number is 240 million (Zhu and Wan, 2012). The difference is a matter of 160-216 million jobs (Zhu and Wan, 2012). Therefore, China still has a long way to go in developing its service industry and maintaining economic growth to generate more job opportunities.

CONCLUSION

To summaries, in order to reducing regional inequality, China needs to have a clear regional development strategy that favours the disadvantaged areas. It is important to allow free movement of labour and capita between the two sectors. It is also important to

open up the inland areas for more international trade and investments. The current efforts to strengthen economic development in the western region show that the government is aware of the inequality problem and is moving in the right direction to tackle this issue (Yao *et al.*, 2004).

As far as I am concerned, there are two main tasks need to be tackle with these policy implications. First of all, new policies should provide more business chances for the inland region. To achieve this goal, the lagging areas need more financial and fiscal support from both the government and market. Moreover, new SEZs required to be built in inland area in order to attracting FDI and foreign trade boosting the development speed there, then, the manufacture industry could move from coastal areas to inland. Thus, more job opportunities will emerge in the central and western regions. Secondly, institutional reform is another significant task to tackle the inequality issue. This require governance reform especially the SOEs reform, government should provide more incentives and opportunities for the private sectors participating the development in inland, this experiment which has been tested in coastal region is a effective way for development. On top of this, social safety net is necessary in institutional reform, social protection system and medical care system need to be built equally through regions and guarantee the impoverished citizens obtain opportunities to develop themselves.

Another significant aspects, when aiming to solve the problems of regional inequality, policy-makers need to focus on human development and the generation of equal opportunities for all the residents in the country as well as on disparities in economic growth.

The government needs to emphasis regional equality in development and the policy implications explored above will both enable this and contribute to the development for the whole country. By helping to create a stable environment such policies will facilitate sustainable development that China needs to maintain its economic and cultural growth in the long term.

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