Inequality and poverty have evolved dramatically in China since the mid-1970s. A team of researchers have measured these changes and sought to identify their key characteristics in order to guide future policies.

They find that overall inequality has unambiguously risen in China over the past two and half decades, with the Gini probably in the 0.40-0.50 range for both urban and rural areas. In urban China, absolute living standards have risen so much that, even with rising inequality, most poverty has been eliminated. In rural China, significant income growth during the late 1970s and early 1980s, resulting from the introduction of the Household Responsibility System (HRS) that allowed households to retain much of their production gains, pulled tens of millions out of poverty. Further growth occurred through the early-to-mid 1990s, followed by some deterioration in the last half of the 1990s.

For a significant number of households, incomes have remained flat or fallen over a decade or more, and the very poor may be worse off. Geography plays a much less important role than one might expect: at least half, and perhaps as much as two-thirds, of estimated inequality is driven by income differences between “neighbors”. Although urban incomes may be on average two-thirds to three-quarters higher than rural incomes, these differences are the source of a relatively small proportion of overall inequality in China. Inequality increased more rapidly in the interior provinces as a result of a more rapid increase in rural income inequality, and a widening urban-rural income differential. In the more dynamic coastal provinces, more rapid job growth in the non-state sector helped reduce urban-rural differentials by fostering more rapid rural income growth, and simultaneously helped to keep increases in rural inequality down.

Our findings regarding the limited role of geography and urban-rural differences suggest that we need to focus more attention on other possible sources of inequality, notably the institutions influencing the allocation of factors of production, including both human and physical capital, and factor returns. In the countryside, most of the level and growth of inequality is explained by unequal access to non-farm family business income in the countryside. In the cities, the decline in subsidies and unequal wage incomes are playing an increasing role in raising inequality. Increasing returns to higher education are very important in explaining growing dispersion of wage earnings. Our results from both urban and rural samples thus underscore the important role likely to be played by education in determining the future evolution of income distribution in China, even though the exact channels may be different in cities and the countryside.

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