It’s hardly news that, apart from the very occasional stumble, the Chinese economy has been setting growth records for decades. From 2002 to 2012 alone, real GDP per capita rose by 146 percent, vaulting China into the league of middle-income nations and making it the second-largest economy in the world. Moreover, though China has traditionally been marked by regional inequality, this breakneck pace has greatly improved living standards across the country and — contrary to received wisdom — has, in recent years, even worked to narrow the gaps among regions. Yet I would argue that ongoing unease about inequality is justified: to lock in the gains, the Chinese government needs to take aggressive action to equalize access to social services.
REGIONAL INEQUALITY, FROM MAO TO DENG

In the early years after the Communist revolution, the economy was marked by two parallel divisions – coastal and inland, rural and urban. In 1955, per capita GDP in heavily industrialized provinces like Liaoning and Heilongjiang was more than double that in inland provinces like Hubei and Henan. That was unacceptable to the Chinese leadership, which made it a priority to moderate regional inequality for the sake of political cohesion. To manage that task, Beijing centralized fiscal expenditures and increased both investment and basic services in poor provinces. Doing so involved both substantial revenue-sharing between the national and local governments and transfers of human capital. The famous example of the latter was the provision of “barefoot” doctors, health care workers in the countryside. Though those doctors had only modest training and few drugs to offer, a little went a long way. Their efforts, which included help in improving sanitation and diet, sharply reduced infant mortality and the incidence of epidemics. The payoff: between 1950 and 1965, life expectancy at birth (across China) rose by a spectacular 18 years.

However, many of the programs designed to address regional inequalities were washed away by the waves of economic liberalization in the late 1970s and early 1980s. When agriculture was privatized, village communes lost the financial resources to pay for social services. Liu Yuzhong, a barefoot doctor in the late 1970s (and now a senior staff member at the National Institutes of Health in the United States), recalls that the immediate effect was

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Although laws barring migration have since been relaxed, farmers moving to the cities are still made second-class citizens by hukou.

the reemergence of infectious diseases associated with extreme poverty.

Urban areas, by the way, did not entirely escape collateral damage from the changes. As part of the effort in the 1990s to make state-owned enterprises more competitive, many employees lost their government-funded health insurance. Thus, although the 1990s was a period of dramatic growth, the increase in prosperity coincided with the fraying of the none-too-adequate social safety net.

The hukou household registration system, a legacy of Chinese feudal social control, exacerbated rural-urban divisions. The hukou is akin to a domestic passport, controlling where a person can legally live, work and receive government benefits. It is based on the hukou registration of one’s parents. Historically, hukou was used to tie peasants to the land and to prevent farmers from flooding into the cities – a goal rationalized by post-revolutionary governments as a means of preventing social disorder and the chaos of slums. However, it had the unfortunate consequence of excluding large swaths of Chinese society from getting their share of the fruits of the spectacular economic growth dividend in the 1990s.

The hukou system had a particularly severe effect on urban-born young men who had been ordered to the countryside to learn proletarian virtues from the peasants during the
Cultural Revolution (1966-76). Many of them settled down and started families. But when Deng Xiaoping rose to power in the late 1970s and those exiles were allowed to return home, they found themselves trapped by the hukou system that prevented them from bringing their families. This tragedy is the stuff of many a modern television melodrama in China, as well as a vivid reminder of the long shadow of hukou in Chinese history.

Although laws barring migration have since been relaxed, farmers moving to the cities are still made second-class citizens by hukou. They cannot receive housing subsidies, education, health care, state-sector jobs, job training or unemployment insurance in their new locales. The children of migrant workers are especially disadvantaged: even if they go to school in the cities, they must return to the provinces in which they are registered to take the competitive exam for entry to universities. This is a greater handicap than might be imagined, because the prospects of getting into a top school are much better for city residents. Holders of Beijing hukou, for example, have an estimated 40-to-1 advantage over the average Chinese test taker for getting into a prestigious university in the capital.

A REVERSAL?

All that said, regional income inequality has been falling in recent years. The coastal provinces did run far ahead in the 1990s, on the strength of export-led private industrialization. But the trend has since been reversed – a reality that may still surprise your average policy wonk because the bulk of studies on Chinese income inequality focused on the earlier post-liberalization period of divergence. What’s more, the pace of the narrowing has been brisk: a province with half the average national per capita income in 2001 could expect to grow two percentage points faster annually than the country as a whole across the decade. One way of measuring regional inequality is by comparing population-weighted Gini coefficients for regions as a whole, in effect assuming that every individual within a province has an identical income. By this metric, regional inequality in investment and GDP per capita has never been lower. And although regional inequality in consumption is still elevated from historical levels, it has been falling in the past few years.

There are five main causes for this change. First, central government investment has been increasingly aimed at making the inland provinces more competitive. Since the start of China’s official “Go West” development strategy in 2001, Beijing has poured more than 325 billion RMB – in the ballpark of $60 billion in terms of today’s purchasing power – into transportation infrastructure in the western provinces. In addition, many new high-speed rail developments, such as the Yichang-Wuhan high-speed line that opened
in 2012, serve inland China. These high levels of investment, especially in interior cities like Chongqing and Wuhan, have no doubt helped to spur their rapid growth.

Second, the government has made an effort to close the income gap through more social spending in western and inland areas. From 2004 to 2010, social outlays grew in real value at a rate of 15 percent per year.

Some of the funds were directed toward a new rural health care insurance system. By 2009, this system was up and running in 95 percent of China’s county-level administrative units, and covered two-thirds of the total population. The government is continuing to spend extensively on this program, now with the goal of increasing the average reimbursement rate on health care bills from 30 percent in 2007 to 70 percent or more.

Another important change has been the introduction of a rural pension plan. By the end of 2011, it covered 40 percent of all counties in China. Since many of China’s inland provinces are still primarily rural, this represents a large transfer of resources that serves to equalize income and health care.

Third, in addition to beefing up these iconic social programs, the government has channeled a lot of funds toward farm subsidies. The agricultural tax was phased out, beginning in 2004, and direct subsidies for seeds and agricultural machinery were introduced. Price floors were set for wheat and rice and the government stepped in to defend those floors by buying and selling buffer stocks. Expenditures have grown rapidly, reaching $75 billion in 2012, with subsidy payments to grain producers now equaling 7 to 15 percent of their income.

A fourth major driver of the reduction in regional inequality is old-fashioned catch-up growth. Part of the reason China as a whole has been able to sustain such high growth rates is that it is still relatively underdeveloped. Justin Lin, a former World Bank chief economist, has observed that China’s relative

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**FOREIGN INVESTMENT GROWTH, 2001-2011**

![Diagram showing foreign investment growth from 2001 to 2011, with a focus on inland and coastal regions.](source: China Data Online; author's calculations)
backwardness in technology means it can grow through “imitation, import and/or integration of existing technologies and industries.” As a result, China is enjoying a period of accelerated growth as it narrows the productivity gap with the West.

But what is true for China relative to the world is also true for Chinese provinces relative to each other. Note, by the way, that this reality has piqued interest from global investors as well as domestic ones. Growth in foreign direct investment in Sichuan, for example, has increased by a factor of nine over the past decade, far more than in Shanghai, Guangzhou and Beijing. This suggests that the interior economy has more going for it than government fiat. Foxconn, the giant Taiwan-based manufacturer, offers a good example of this inland pull. “Henan and Sichuan have always been the largest sources of migrant workers,” Louis Woo, a Foxconn spokesman, explained. “That was why we moved to both.”

The fifth driver has been domestic migration. Because hukou laws have been relaxed to encourage migrants to take low-skilled jobs in construction, manufacturing and services in labor-short cities, there has been an exodus of workers from rural areas. The sheer magnitude of this migration is evident every year during the Spring Festival, when hundreds of millions (yes, hundreds of millions) crowd the rails and the roads to visit their families.

THE ROAD AHEAD

By any objective standard, Beijing has done well in balancing the sometimes-competing objectives of maximizing aggregate economic growth and minimizing regional income disparities. To make further progress in reducing regional disparities, though, it will need to focus on the urbanization of the inland provinces. That is because much of the income gap can be explained as a gap in urbanization.

However, this second wave of urbanization must differ qualitatively from the first. According to the Chinese National Bureau of Statistics, the proportion of Chinese living in cities has risen from around 20 percent in the
early 1980s to 50 percent today. Most of the migrants have been laborers in search of higher wages. As a result, young adults are overrepresented in the population, while children and the elderly are underrepresented. According to the 2009 population survey, the proportion of people in cities under the age of 20 was about two percentage points lower than in the villages – and just the reverse for those between 20 and 39.

The sacrifices implied by this demographic twist have been heavy: millions have been forced to leave their children behind, to be cared for by grandparents. And this division of families is serving as a powerful deterrent to further migration. Thus, if urbanization is going to continue apace, it will need to make room for dependents – both children and the elderly.

To facilitate this transition, provincial governments need to liberalize access to urban social services for migrants and their families. Today, most of those people lack health insurance and old-age pensions that are valid in cities. Moreover, their children generally cannot attend public schools without paying fees.

While it’s tempting to narrow regional inequality more directly by means of direct cash transfers to households and rural communities, there are good reasons to expand social service access in cities instead. For one thing, there are economies of scale in urbanization: researchers have shown that large cities are more efficient than less-dense communities in providing social and environmental services.

Consider, for example, health care. While a system of barefoot doctors may have yielded immense social returns in Mao’s time, the low-hanging fruit has been picked. And it has proved very difficult – read very expensive – to convince doctors and other highly trained practitioners to move to the countryside to deliver care. The more efficient strategy would be to bring more of these rural residents into the cities and to improve the quality of hospitals and clinics there.

The same holds for education. It is much more costly to build and maintain quality schools – and to hold onto students – in rural environments. Data from the 2010 Chinese population survey show that only half of rural Chinese have more than a middle-school education, whereas the comparable number for urban Chinese is 80 percent. The problems created by inadequate rural education will only grow worse as China gets richer, the composition of GDP evolves toward sophisticated services and the demand for skilled workers rises disproportionately.

Second, using social services to facilitate urbanization in China’s interior would allow inland provincial economies to specialize. For broader prosperity, it is critical that each province develop comparative advantages in production – and, in particular, gain a foothold in the sorts of industries needed by a far more affluent economy. But without the large local markets and economies of scale afforded by cities, this process will likely be retarded.

The evidence to date supports this view. From 1980 to 1995, 22 of the 25 broadly defined industrial groupings in China – for example, both finance and construction – became more geographically concentrated. This suggests that there are agglomeration economies in many Chinese industries.

To be sure, there’s a conceptual issue here: growth may cause urbanization, rather than vice versa. Or, most likely, causality runs in both directions. But that is hardly a reason to sustain the current institutional bias against urbanization – the constraints imposed by hukou and the pressure to stay in rural areas to obtain basic family services.

Then there’s the moral dimension. Ongoing urbanization is critical to China’s growth
and social cohesion. But it's hard to argue that the burden of change should be borne disproportionately by migrants and their families. Improving social services for new arrivals to the cities, particularly assistance with housing and schooling, seems an obvious policy choice on ethical as well as practical grounds. It would be a win-win for migrant families and the Chinese state.

A push to urbanization should not be interpreted as abandonment of agriculture. Rather, the strategy is geared toward convincing people to leave the farms in favor of more productive work. It's important not to lose sight of the fact that while reducing regional inequality is important in its own right, the primary goal should be to reduce the inequality of opportunity (and, arguably, outcomes) for people born in each region.

**WHO PAYS, HOW MUCH**

A back-of-the-envelope calculation shows the expenditures that would be needed to provide social services for migrants and their families in an urbanized interior. A good benchmark for education expenditures in the inland provinces would be Guangdong in 2005, which had a GDP per capita of 20,000 RMB (in year 2000 prices) and a very high urbanization rate (around 60 percent). Today, inland provinces have approximately Guangdong's 2005 level of GDP per capita income, but much lower urbanization rates.

Back in 2005, Guangdong enrolled 18.7 million students in all levels of education, and spent a total of 28 billion RMB – roughly 1,500 RMB per student (again, in year 2000 prices). If the Chinese government were to devote this sum to each of the estimated 61 million children left behind in the countryside, the annual bill would run to around 91.5 billion RMB – around 12 percent of China's 2010 total educational expenditures and a tiny fraction of the country's annual increase in GDP.
The money could come from Beijing. Or local governments could raise the funds through higher business taxes and higher dividends from state-owned enterprises. This could be viewed as a quid pro quo between regional businesses and government, in which companies would benefit from access to a larger, better-educated pool of young workers. Note, too, that the resulting increase in the supply of trained urban workers would reduce the pressure to raise wages in labor-scarce cities—a significant bonus for a Chinese economy that is now facing competition from lower-wage industries in Vietnam and Indonesia.

THE BEGINNING OF THE END OF HUKOU?

There’s a near-consensus that comprehensive hukou reform overnight would be impractical. The resulting pace of migration would exceed the cities’ capacity to meet the added demands on services ranging from schools to mass transit, even if the money were available to pay for them. But the best should not be seen as the enemy of the good; a more gradual transition would avoid social turbulence (and the potential for backlash), as well as giving local governments a chance to experiment with delivery methods for social services.

Guangdong has already taken steps toward making this kind of piecemeal reform of hukou a reality. Since 2010, the province has allowed migrant workers to enroll their children in schools after five years of residence and to apply for hukou registration after seven. While there is a list of requirements for the parents, none involve high educational attainment or specialized skills. Instead, they focus on making sure that parents have paid their taxes and obeyed the law.

Efforts to phase out the impact of hukou are also coming from a very different direction. Tongling, a deeply depressed copper mining city in the impoverished rural province of
Anhui, is attempting to convert itself into a manufacturing center by expanding education, health care and housing benefits to migrants. And it's apparently beginning to work: the city’s population has been edging up since 2008, even as Anhui’s total population fell.

There have been glimmers of reform in higher education as well.

Since 2012, Beijing has permitted high school students with hukou registration in other regions to take their examinations in the capital. Many other coastal provinces have followed suit. And since a university education plays a vital role (symbolic as well as real) in the minds of the Chinese, this represents an important step towards integrating rural migrants into urban society.

The national government is apparently marching to the same drummer. In October, the Chinese State Council Development Research Center released a framework proposal for social service expansion and local public finance. It suggested, among other things, that Beijing is prepared to impose a national consumption tax, with the revenues funneled to local governments. The proceeds would pay for a nationally mandated “citizen basic social protection package” – the first step to delinking social services from hukou registration nationwide.

There is legitimate concern that the decentralized nature of the Chinese governance system may complicate the process of expanding service provision. Although China has a unitary system of government with final authority over policy concentrated at the top, revenue-raising and the delivery of government services have been decentralized since Mao’s time.

The risk here, then, is that provinces will try to pawn off the provision of social services on others, creating a classic race to the bottom. However, in light of the changing economic environment, this is not likely, because high-quality social services now constitute a powerful attractor for business. Education is one example of this, of course, but transportation and amenities like parks and recreation matter, too. In any event, this potential for a vicious cycle would be reduced if the central government absorbed much of the financial burden during the expansion of social services.

Note, too, that a race to the bottom is not consistent with the history of reform in post-revolutionary China.

The agricultural reforms in the 1970s that allowed households to sell their surpluses on free markets were not imposed from the top. Rather, popular pressure led the central government to give in. The process of market reform in China has long been described as “crossing a river by groping for stones.” And so social service reform, like Deng Xiaoping’s “Reform and Opening Up” program, three decades earlier, will be based on this kind of decentralized experimentation.

FINISHING THE JOB

Deng famously declared in the 1980s that for a country to become rich, it must let “some people get rich first.” That was a stark departure from Maoism, which had focused on reducing inequality, even at the cost of slower growth. However, Deng’s declaration had another implication that is often forgotten. He was willing to tolerate rising regional inequality because he strongly believed that allowing the coast to become wealthy first would ultimately provide the best chance for the inland provinces to improve living standards down the road.

His vision has been fulfilled in part, and the means for finishing the task are at hand. The real question now is not whether, but when.