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Tackling social challenges to avoid the middle-income trap

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[T]hey have not any difficulties on the way up, because they fly, but they have many when they reach the summit.

— Niccolò Machiavelli, *The Prince*

Introduction

In 2018, the Chinese economy grew to equivalence to the economy of the euro area or two-thirds of the economy of the United States and accounted for 16 per cent of the global economy. With a growth rate of 6.1 per cent in 2019—higher than any other major economy—the Chinese economy further raised its importance in the world economy. At the same time, China’s gross domestic product (GDP) per capita exceeded US\$10,000—significantly above the average level of the upper middle-income countries.¹

Many economists, think tanks and international institutions believe China’s growth will continue to be robust in the near future. China is already in its transition to high-income status and seems certain to cross the threshold between middle-income and high-income countries in a few years. According to international experiences, this stage of development is critical to maintaining economic growth and social stability. In what follows, we summarise some aspects of those experiences.

¹ Unless noted otherwise, this chapter uses the World Bank’s criteria of 2010 US dollars to identify low-income countries (US\$1,005 GNI per capita), lower middle-income countries (US\$1,006–3,955), upper middle-income countries (US\$3,956–12,235) and high-income countries (> US\$12,235).

First, although the World Bank set a level of gross national income (GNI) per capita as the threshold for high-income countries (currently US\$12,235), there has never been a guarantee that countries that fulfil the income criterion will maintain their high-income status; nor is the criterion a guarantee for sustained growth. Additional indicators are needed to determine whether a country can sustain its development. Indicators of social development are particularly important as they can embody the purpose and sustained sources of economic development.

Second, for most of the upper middle-income countries close to the high-income threshold, economic growth tends to slow, while there is divergence in growth performance among countries (Eichengreen et al. 2011, 2013). Countries that fail to properly tackle the slowdown—and, as a result, perform poorly in social development—often become stuck in the vicious cycle of growth stagnation and income gap widening, which economists call the ‘middle-income trap’.²

Third, as the low-hanging fruits of growth drivers become scarce and opportunities to implement reform characterised by Pareto improvement diminish, countries must tackle the economic slowdown while also maintaining social mobility. Making a bigger pie and dividing it fairly require further reform by breaking up vested interests, tapping into new sources of growth through innovation and strengthening government redistribution.

Since China entered the group of upper middle-income countries (with per capita GDP exceeding US\$4,000) in 2010, its demographic transition has shifted into a fundamentally different phase. The working-age population (aged 15 to 59) has been in rapid decline and the population dependency ratio has increased accordingly. As a result, labour shortages, slower human capital improvement, diminishing returns to capital investment and decelerated labour migration (which slows productivity increases) all lead to the weakening of potential growth capacity and a slowdown of actual growth.

The average annual growth rate of GDP fell significantly, from 10.1 per cent in the period 1980–2010 to 7.0 per cent in the period 2012–19. According to estimates of China’s potential growth rate, its economy will continue to follow a downward trend until the growth rate regresses to the mean.³

2 Gill and Khara (2007) first use this concept for analysing challenges facing East Asian economies, whereas many researchers more often refer to Latin American countries as typical examples of it.

3 Pritchett and Summers (2014) predicted China’s growth rate would regress to the mean (the average rate of the world economy) in 2015, which was proven wrong. As Cai and Lu (2013) estimate, as the deceleration of China’s potential growth rate is moderate and gradual, the actual growth rate is expected to remain reasonably high compared with most other major economies for some time, regressing to the mean sometime close to 2050.

How the benefits of development are shared among the people lies in both the speed of making the pie and the mechanism of dividing it. With distribution patterns unchanged, slower growth of output tends to mitigate the level of sharing and to change the nature of sharing. In China, the narrowing trend of the income gap has retreated moderately since growth began to slow. The falling trend in the Gini coefficient of household income—from 0.491 in 2008 to 0.462 in 2015—has stalled since 2016. As for the distribution of household disposable income, its improvement was even more short-lived. The ratio of the top 20 per cent to the bottom 20 per cent in the quintile of urban household disposable income decreased from the high point of 5.77 in 2008 to 5.00 in 2012, and then increased to 5.90 in 2018. The same ratio for rural household income decreased from the high of 8.39 in 2011 to 7.41 in 2013 and then increased to 9.29 in 2018.

This chapter investigates global experiences based on cross-nation data to shed light on why economic growth slows and social development stagnates in the upper-middle-income stage. It particularly focuses on lessons that have implications for China as it transitions to high-income status.

Section two describes the changes in the economic growth rate and income distribution in relation to development stages based on cross-nation data. Section three explains why the economic slowdown tends to reduce social mobility in China. Section four explores institutional obstacles to social mobility in China's transition to high-income status. Section five concludes with a suggestion that, in response to the unique challenges facing China, redistribution policy should focus on equalising access to basic public services.

The economic slowdown and consequent worsening of distribution

Conventional theories of growth consider economic development as a homogeneous process—that is, nations expand their economy and increase per capita income by following a predetermined path without disturbance by changes in development stages. Under the neoclassical growth theory, the hypothesis of conditional convergence that correlates growth performance with initial per capita income expects countries with low incomes at the starting point to grow faster than those with higher initial incomes once they have the necessary endowments, institutions and infrastructure in place. The difference in growth rates between poorer and richer countries leads to a convergence among countries (see, for example, Barro and Sala-i-Martin 1995).

Those theories pay little attention to the differences in growth patterns between countries at different stages of development.⁴ These differences, however, are what result in differentials in economic performance and related social development.

A simple observation of the relationship between initial income and subsequent growth performance suggests that, if there is any convergence, it closely relates to the stage of development. In Figure 2.1, we show the descriptive relationship between per capita GDP in 1990 and its growth rate in 1990–2018.

Figures 2.1a and 2.1b present scenarios for all 214 countries (and territories) with data availability and for 164 low and middle-income countries with per capita GDP lower than US\$12,000, respectively. In both scenarios, there is little correlation between initial income and the growth rate—that is, no convergence is found.

Figure 2.1c presents the scenario for 116 middle-income countries with per capita GDP between US\$1,000 and US\$12,000. In this manifestation, there is an insignificant correlation between initial income and later growth, showing only a vague convergence. In the scenario expressed by Figure 2.1d, which includes 43 upper middle-income countries with per capita GDP between US\$4,000 and US\$12,000, the correlation between initial income and later growth and thus convergence is more apparent relative to the aforementioned scenarios.

These descriptive presentations of hypothetical convergence reveal the reality of developing countries in catching up to their more advanced counterparts in the period concerned.

Many low and lower middle-income countries have been stuck in a low-level equilibrium trap due to a lack of the necessary conditions for economic take-off, which is manifested in their cumulating around the threshold between lower middle-income and upper middle-income status. In such stages of development, countries vary significantly in terms of growth performance, with some being superstars in catching up and others trapped in stagnation.

Those low and middle-income countries that have successfully caught up with their high-income counterparts have by and large experienced the development of a dual economy and thus benefited from the demographic dividend. As can be predicted by the definition of convergence itself, the upper middle-income countries in such a state tend to see a moderate slowdown, because of a diminishing labour supply, high investment returns, resource reallocation efficiency and the advantages of technological backwardness.

⁴ Though empirical studies on 'convergence clubs' group together countries in different stages of development to see how they grow differentially, they do not particularly employ the perspective of development stages. For example, see Baumol (1986).

2. TACKLING SOCIAL CHALLENGES TO AVOID THE MIDDLE-INCOME TRAP

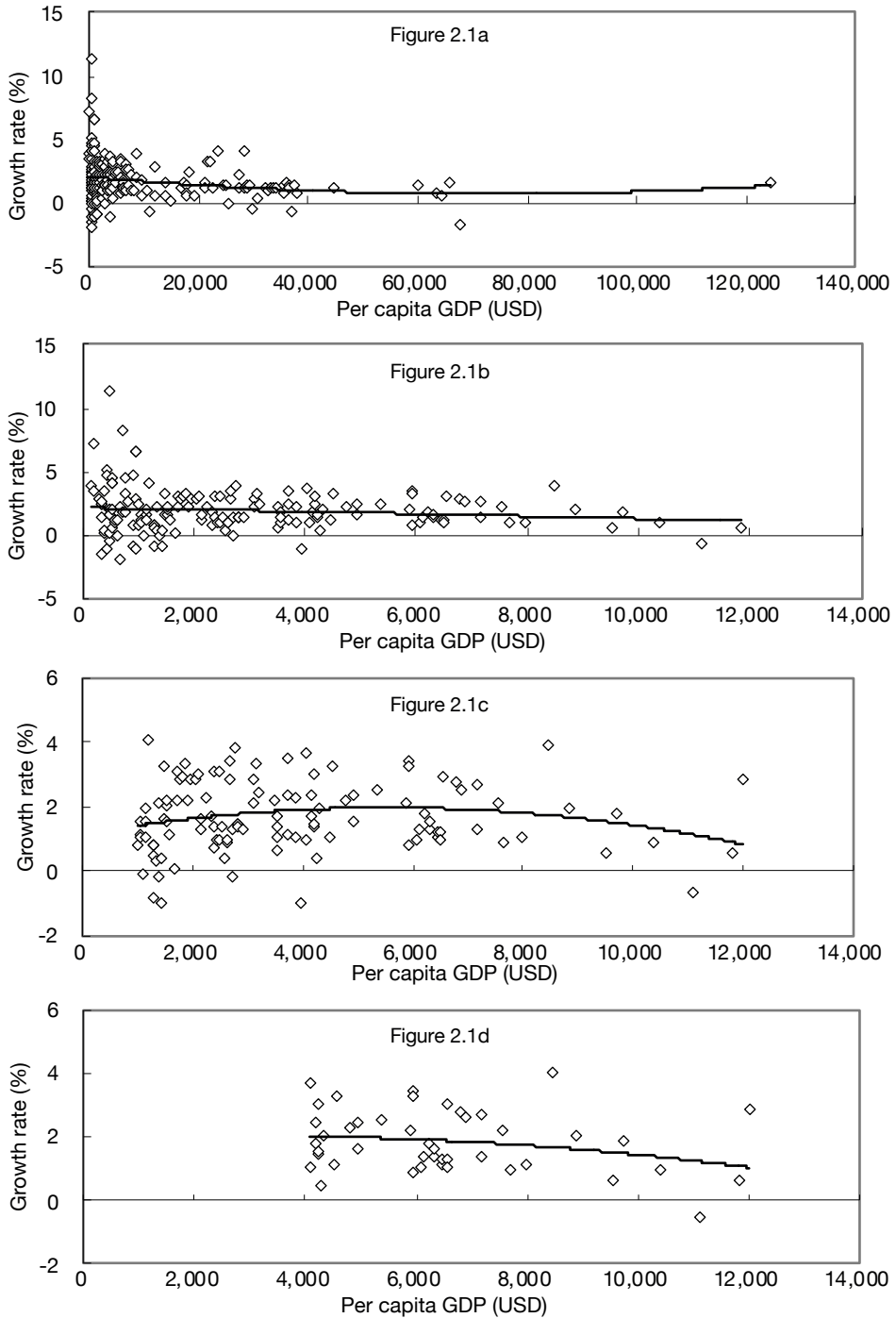


Figure 2.1 Stage of development versus economic growth

Source: World Bank (2021).

As is shown in Figures 2.1c and 2.1d, in the middle-income stage, and especially the upper middle-income stage, growth rates show a tendency for convergence among countries.

Those countries that experienced a slowdown in the later stage of transition to upper middle-income status—particularly near the high-income threshold—tended to diverge in growth performance depending on how successfully they tackled the growth slowdown. It is such a critical period that divides countries on to different tracks: moving up to high-income status or falling into the middle-income trap.

Let us turn to the nexus between income distribution and stages of development. By plotting data collected from the early industrialised countries, Kuznets (1955) found an inverted U-shaped curve for income inequality. That is, as per capita income increases, income inequality measured by, say, the Gini coefficient rises in the early stage of development and, after peaking—or reaching the Kuznets turning point—it begins to decline. Kuznets's observation has been widely criticised, in part because it is not confirmed by new evidence and in part probably because it has been cited to support various versions of 'trickledown economics'.

Again, we use World Bank data to see what the relationships between per capita GDP and the Gini coefficient look like in relation to stages of development. From Figure 2.2a, which plots 119 low and middle-income countries, one cannot find the pattern suggested by Kuznets where the Gini coefficient increases with increasing per capita GDP.

Figures 2.2b and 2.2c present income distribution in 94 middle-income countries and 40 upper middle-income countries, respectively, and both show little correlation between per capita GDP and the Gini coefficient. It is worth noting from these two figures that upper middle-income countries typically have high inequality.

Figure 2.2d depicts the pattern for all 153 countries with data availability. Since this scenario is formed after adding samples of high-income countries to the previous scenarios, the appearance of a Kuznets curve should be credited to high-income countries' pattern of income distribution.⁵

Some coarse findings are summarised here. First, the Kuznets curve does not exist—at least according to the data shown in Figure 2.2. Nor is there any empirical evidence to support an increasing Gini coefficient in step with per capita income in the early stage and a mechanical Kuznets turning point.

5 The diverging trends in income distribution among countries, especially among upper middle-income countries, deserve to be noted. That is, with the increase in per capita income, income distribution has been improved in some countries, while it has deteriorated in others.

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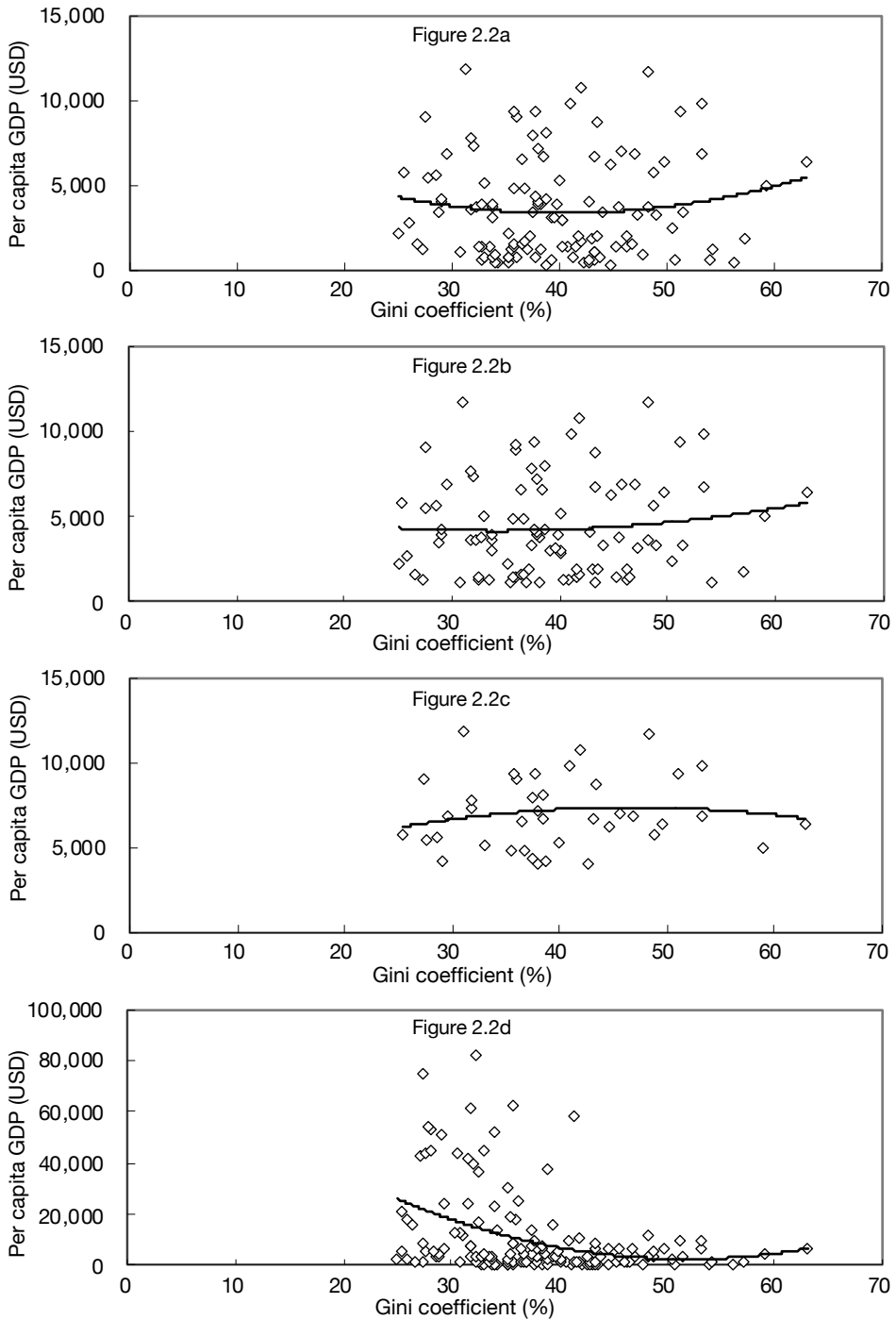


Figure 2.2 Income distribution and stages of development

Source: World Bank (2021).

Second, although there is great variation in the income inequality index among countries in all stages of development, there appears to be a certain nexus between the Gini coefficient and per capita GDP, especially when looking at the upper middle-income and high-income countries. That adds to the evidence that upper middle-income countries are subject to the middle-income trap, which usually manifests in an economic slowdown and a widening of the income gap.

Third, the smaller Gini coefficients—namely, equitable income distribution—shown in high-income countries are actually the results after adjustment for taxes and transfers. Together with the second finding, it can be said that redistribution policies become increasingly important when countries enter the upper middle-income stage and move to the high-income stage.

The same factors that cause a growth slowdown in the upper middle-income countries weaken the function of the labour market in reducing inequality and social mobility (primary distribution). In this stage of development, as redistribution policies are not yet well prepared, countries are apt to be troubled by worsening income distribution.

Admittedly, redistribution and related policy measures do not necessarily result in a narrowing of the income gap. In reality, there are many cases where redistribution policies either remain little more than window dressing due to slower growth or actually increase inequality as a result of the stronger bargaining power of vested interest groups. Still, such phenomena imply that this is a critical stage at which to introduce redistribution policies and choose an effective way of implementing them. What these findings imply for China in promoting social mobility in its transition to high-income status will be discussed in what follows.

Changes in social mobility as China moves to higher-income status

What we conclude so far is that the stage of development is helpful for understanding economic growth and social development and for interpreting countries' success or failure in these processes. In moving closer to high-income status, China has witnessed not only an economic slowdown but also weakening social mobility.

The fruits of rapid growth of the Chinese economy during the reform period from the late 1970s have been widely shared among Chinese people, mainly through labour market mechanisms. The nature and mechanism of sharing have been closely related to China's specific development stage and the unique growth pattern the Chinese economy adopted in the period—until both changed.

From the 1980s to the 2010s, China had a favourable opportunity window with regards to population, in which the working-age population increased and the population dependency ratio declined—both rapidly. Relevant reforms that eliminated institutional obstacles to labour migration have transferred surplus labourers in agriculture and redundant workers in urban enterprises to employment in newly emerged sectors, which has simultaneously enhanced the incomes of rural and urban households and reallocated resources in the economy as a whole.

Through participation in the global economy, China's abundant labour force has translated into comparative and competitive advantages for manufacturing commodities. Capitalising on its comparative advantage in labour-intensive manufacturing in global industrial chains, China exchanges its abundant labour factor for capital factors, with which the developed countries are abundantly endowed.⁶ By and large, such a trading pattern tends to increase returns on labour in China and, therefore, Chinese workers have shared the benefits of reform, opening up and the resulting growth.

Specifically, in the period when there was a massive surplus of labourers in agriculture and redundant workers in urban enterprises, which curbed the increase in wages, total income and the share within it of the wage earnings of rural and urban households increased through fuller participation in wage employment. As the economy passed the Lewis turning point,⁷ total income and its share of rural and urban household wages increased more depending on wage rate inflation, as employees gained stronger bargaining power in the labour market.

Therefore, for most of the past four decades, China's development process has been characterised by the synchronisation of economic growth, employment expansion and income increases. In the period 1978–2019, the annual growth rate of commodity imports and exports was 18.4 per cent in nominal terms, and the annual growth rates in real terms were 9.4 per cent for GDP, 4.0 per cent for employment in secondary and tertiary sectors and 8.4 per cent for per capita disposable income.

As the demographic window closed after the three decades from 1980 to 2010, the Chinese economy has no longer been characterised by an unlimited supply of labour. This is manifest in the slowdown in labour migration, which has resulted in slowing growth of urban employment, a weakening comparative advantage in manufacturing and declining shares of Chinese commodities trading with developed countries.

⁶ From the 1980s to the 2000s, the share of China's commodities exports to developed countries remained above 75 per cent, while the share of China's commodities imports from developed countries was also high. Both shares have since been in a declining trend.

⁷ Cai (2016) suggests 2004 can be viewed as the Lewis turning point in which a labour shortage occurred in China's coastal areas and was afterwards widespread throughout the country.

It can be expected that, along with these changes in the economic domain, improvements in income distribution will tend to decelerate and, most importantly, social mobility will weaken. We can observe social mobility and its trend from both horizontal and vertical perspectives. In general, through labour migration—namely, horizontal mobility—individuals and families can realise their desired vertical mobility by changing their occupation and income status across time, cohorts and generations. So, social mobility is not only about reallocation of labour and population; most importantly, it is also about patterns of social stratification, a sense of happiness, consensus on ideas of social justice and thus social cohesion. In what follows, we discuss the trends of social mobility in China via some revealed indicators.

Since the reforms initiated in the late 1970s, China has witnessed surplus labourers transferring from agriculture and migrating from rural to urban sectors, which has led to substantial changes in sectoral structures and regional patterns of development. In the period 1978–2018, the share of agricultural labour in total labour declined from 70.5 per cent to 26.1 per cent, while the proportion of the permanent urban population in the total increased from 17.9 per cent to 59.6 per cent.

As the result of the demographic transition and labour reallocation, however, labour migration has decelerated in recent years (see Cai et al. 2016), as is shown in Figure 2.3. This diminishing trend in labour mobility between rural and urban areas and across regions and sectors tends to drag down social mobility, which is manifested as changes in occupation, income status and social identity.

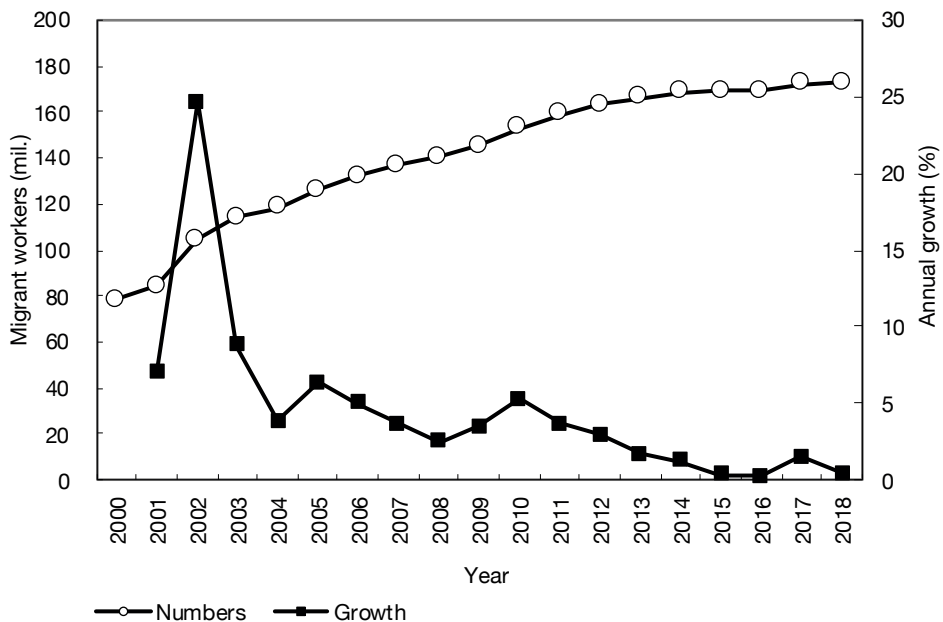


Figure 2.3 Trends in labour migration

Sources: Early data are from estimates in Cai (2016: 30); updated data are from NBS (2019).

Theoretically, in a stage of development characterised by rapid economic growth, marked changes in sectoral structure, dramatic expansions in education and massive labour mobility across regions and sectors, a country's occupational structure tends to rapidly upgrade towards a more human capital-intensive pattern, which promotes overall upward mobility across society. Meanwhile, while society creates more opportunities for people to climb the occupational and income ladders, it does so without the expense of others moving downward. Greater upward mobility and less downward mobility mean that, not only is economic development shared, but also social mobility experiences a Pareto improvement.

There are two critical factors in elevating the occupational structure: the upgrading of the sectoral structure as a demand-side factor and improvements in the education of the working-age population as a supply-side factor. Both have seen substantial changes in the past decades in China, forming the unique pattern of social mobility and its change.

Based on data from the fifth and sixth national population censuses (in 2000 and 2010, respectively),⁸ we calculate two indicators to see such changes. The first is years of schooling by age. According to each age's school completion rate, we assign zero for no schooling, completion of primary school is six years, nine years for junior high school, 12 years for senior high school, 15 years for junior college, 16 years for university and 19.3 years for graduate school (weighted average of master's and PhD students). The second indicator is the proportion of technical personnel and office staff among workers,⁹ which is supposed to show the state of occupational upgrading.

Plotting the indicators in Figure 2.4, one can find two features concerning educational attainment and occupational upgrading in relation to time and age. First, both human capital and the job mobility of employees improved significantly in the period 2000–10, which shows mutual promotion among economic growth, structural change and education expansion.¹⁰ Second, from comparisons at specific points across ages, the average education and occupational upgrading in 2000 and 2010 decreases as age increases. This implies that, while human capital plays a positive role in promoting job mobility, population ageing tends to weaken the human capital endowment and job mobility.

8 Please refer to the website of the National Bureau of Statistics of China (data.stats.gov.cn) for more details of the fifth and sixth national population censuses.

9 One can consider it a proxy of the proportion of 'white-collar workers', though we omit those who are identified as cadres because that categorisation does not distinguish management personnel from administrative and government cadres.

10 Compared with the developed countries, the uniqueness of the Chinese case is the rapid development of both its economy and its education system. In the United Kingdom, for example, the role of education in occupational change is not decisive. See Goldthorpe (2016).

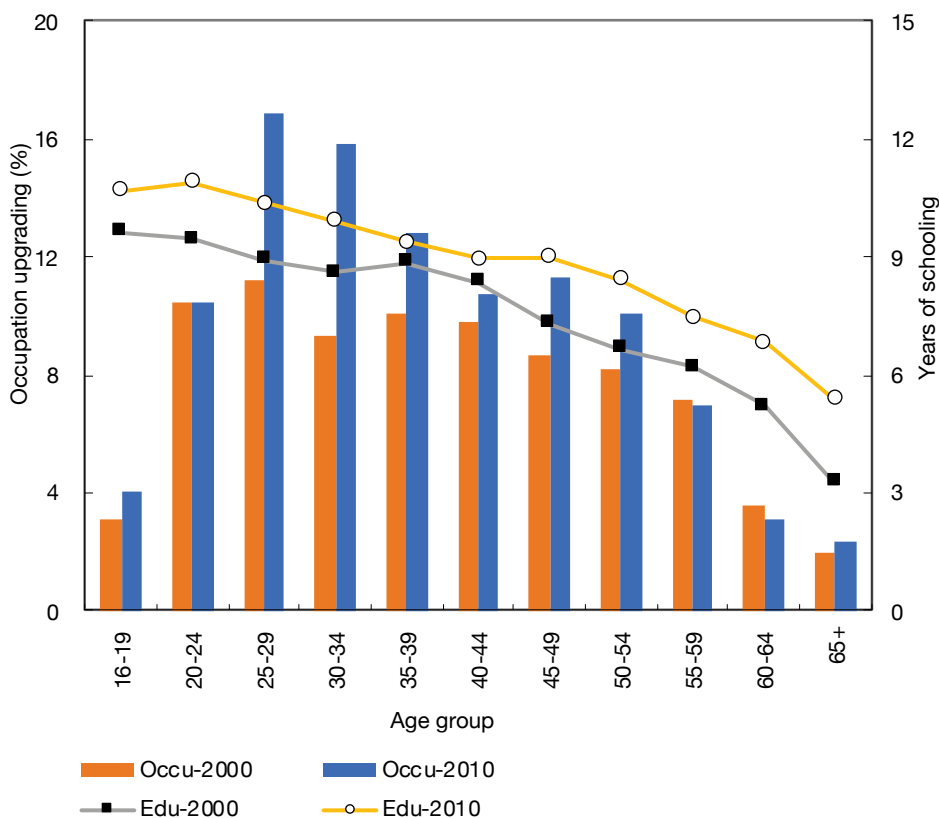


Figure 2.4 Educational attainment and occupational upgrading by age

Source: NBS website: www.stats.gov.cn/.

Further examination shows that the average proportion of technical personnel and office staff in the population aged 16 and older increased from 12.5 per cent in 2002–06 to 18.9 per cent in 2012–17. As those factors that promote occupational upgrading alter, however, one can expect a decelerating trend in job mobility.

Almost all changes accompanied by the disappearance of the demographic dividend—such as slowing human capital improvement, the shrinking share of manufacturing in the economy, contracting employment in the secondary sector and the dominance of the service sector in absorbing employment¹¹—tend to drag down occupational upgrading and thus mitigate social mobility.

¹¹ Unlike employment transfer from agricultural to non-agricultural sectors, which is of productivity-promotion type, the employment transfer from secondary to tertiary sectors has led to a decline in labour productivity of the overall economy. For example, in 2018, the employment share of primary, secondary and tertiary sectors was 26.1%, 27.6% and 46.3%, respectively, whereas their labour productivity (value added per labour) was 32,000 yuan, 171,000 yuan and 136,000 yuan, respectively.

Trends for social mobility, therefore, can move in different directions depending on the country's stage of development. First, with rapid economic growth and structural change, social mobility is more likely to be a type of positive-sum game, or Pareto improvement. It is mainly through this type of social mobility that Chinese residents have been sharing the fruits of economic development over the past decades. Second, in a state of relatively static economic growth and structural change, opportunities for occupational upgrading become scarcer, and some people's upward mobility may be accompanied by others' downward movement. This is also a possible scenario for a slower-growing China.

The scenario in which social mobility takes the form of a zero-sum game may accordingly produce an adverse effect. That is, as all individuals and families strive for the top, those already at the top and trying to maintain their status unavoidably clash with those on the bottom and trying to break the existing pattern of social stratification. Such conflicts in turn make social mobility less of a win-win situation, reducing the sense of happiness at the individual level and of cohesion at the societal level.

The massive expansion of the working-age population, rapid economic growth and a rapidly changing sectoral structure are all phenomena of a particular stage of development, whereas social mobility should occur at any stage of development. Therefore, the way to promote social mobility should be changing over time.

It is widely believed that growth is the ultimate way to eliminate growing pains. However, it is pointless to suggest that the only thing one should do to address the unfairness in dividing the pie is to make a bigger pie. The causes of social immobility and income inequality are rooted in institutions. Therefore, promoting social mobility and reducing income inequality require social and economic reforms. In what follows, we will discuss how China can enhance social mobility and improve income distribution by removing various institutional obstacles.

What institutional barriers deter China's social mobility?

Social immobility not only widens the income gap, it also extends it to future generations, causing solidification of social divisions. As labour market mechanisms increasingly become inadequate to tackle immobility and inequality, the government should step in and implement redistribution policies that include not only progressive taxation, income transfers and public services provision, but also a much broader range of policies that promote social mobility.

In China today, the differentiated access to basic public services between rural and urban areas, across regions and among groups of residents serves as a major institutional barrier, stymieing social mobility—and the household registration (*hukou*) system legitimises such gaps.

The initial purpose of the *hukou* system—established as part of the planning system—was to deter people's migration between rural and urban areas and across regions through strict population registration and segregated, exclusive provision of public services. After its formation in 1958, and except for limited occasions such as university enrolment, military conscription and planned recruitment, there was hardly any migration between regions, and especially between rural and urban areas in the 1960s and 1970s. This blocking of occupational change and the consequent income gap between rural and urban sectors in the pre-reform period made China the least mobile society in the world.

Since the mid-1980s, labour migration between rural and urban areas and between regions has been expanded. However, although the original intention of the *hukou* system has changed, its function of separating the provision of basic public services remains unchanged. The longstanding dual structure of society resulting from this segregation creates a special group of people—namely, migrant workers—who face not only tangible obstacles to becoming legitimate residents of the cities, but also intangible barriers to climbing the social status ladder.

In 2018, there were 172.7 million migrant workers living in places other than the townships in which their *hukou* was registered. As entitlements to public services in urban areas are largely determined by people's *hukou* status, migrant workers (78.2 per cent of whom are in cities) are not treated equally in terms of access to social protection. Based on China Urban Labour Survey (CULS) data,¹² we found significant gaps in workplace treatment and public service provision between migrant and local workers, with only minimal improvement during the period 2010–16 (Table 2.1).

First, migrant workers' wages are still systemically lower than their local counterparts. In 2016, the hourly wage of migrant workers was 73 per cent of that of local workers. Despite migrant workers' efforts to increase their monthly earnings through overtime—for example, their working hours are 26 per cent higher than those of local workers—that does not eliminate the wage gap. Based on data from

12 The fourth round of the CULS was conducted by the Institute of Population and Labour Economics at the Chinese Academy of Social Sciences in 2016. It sampled 15,448 individuals from 6,478 households in 260 communities in Shanghai, Fuzhou, Wuhan, Shenyang, Xi'an and Guangzhou. Of the total sample, 9,753 individuals from 3,897 households were local and 5,695 individuals from 2,581 households were migrants. For details, see: iple.cssn.cn.

an early round of the CULS, Wang (2005) found that *hukou* status could explain 43 per cent of the wage difference between the two groups. That is, after controlling for education and other individual characteristics, the wage gap remains.

Second, migrant workers' participation in social insurance programs is significantly low. For example, the percentage of migrant workers participating compared with their local counterparts is 40 per cent for basic pension insurance, 44 per cent for unemployment insurance and 45 per cent for basic medical insurance.

Table 2.1 Differential treatment in the urban labour market

| | 2010 | | 2016 | |
|--|----------|----------|----------|----------|
| | Migrants | Locals | Migrants | Locals |
| Work and pay | | | | |
| Weekly working hours | 57.00 | 43.70 | 55.20 | 43.90 |
| Monthly wage (RMB) | 2,158.00 | 2,368.00 | 4,839.00 | 5,206.00 |
| Hourly wage (RMB) | 9.80 | 13.50 | 24.10 | 33.00 |
| Coverage rate (%) | | | | |
| Pension insurance | 26.40 | 77.90 | 32.60 | 80.80 |
| Unemployment insurance | 10.40 | 51.80 | 31.60 | 71.10 |
| Medical insurance | 26.30 | 74.10 | 37.50 | 82.60 |
| Other (%) | | | | |
| Children's attendance at local school ^a | — | — | 67.00 | 100.00 |
| Receiving minimum living guarantee | — | 4.20 | 0.70 | 1.90 |

* 'Children's attendance at local school' includes only those at senior high school or lower; as the questionnaire does not ask the location of the school, we presume it is a local school in the surveyed cities.

— No data available.

Because of migrant workers' insecure employment, employers are unwilling to contribute social insurance for migrant workers, migrant workers themselves are not willing to participate in either employee-based or resident-based social insurance programs and many migrants find work through labour-dispatch agencies, which provides both the agencies and the employers with an excuse to exclude workers from social insurance coverage.

Finally, migrant workers also lack equal access to other public services in the cities where they live and work. For example, the proportion of migrants receiving a minimum living guarantee is 35 per cent of that of locals, and only 67 per cent of migrant children attend local schools. According to the National Bureau of Statistics (NBS 2019), the proportion of migrant children attending local public and private schools (with government financial support) is 82.2 per cent and 11.6 per cent,

respectively, at the primary level, and 84.1 per cent and 10 per cent at the secondary level. As for migrants' housing, 19 per cent were purchased, 61.3 per cent were rented, 12.9 per cent were provided by employers and only 2.9 per cent were provided through a local government subsidy.

Conclusion and policy suggestions

In the upper middle-income stage of development, even though an economic slowdown naturally occurs, relatively moderate but more sustainable growth can be realised if the growth pattern can be transformed to fit the new stage. Similarly, nurturing labour market competition and implementing more redistribution policies can maintain social mobility and thus the sharing of the fruits of development.

What challenges China today is that the existing institutional barriers stymie social mobility in general and the *hukou* system, in particular, prevents labourers from fully integrating into cities. There is a paradox to removing those barriers—that is, on the one hand, it is the central government's responsibility to initiate the necessary reforms and, on the other, central and local governments are the ones who must practically implement existing policies. In what follows, we suggest some policy proposals to solve that dilemma.

The first is to separate public service provision from *hukou* by introducing more inclusive, universal social protection programs. At present, the provision of basic social insurance, guaranteed minimum living standards, compulsory education and subsidised housing is the responsibility of local governments. That local governments provide basic public services in accordance with de facto residence status (living in cities for six months or longer) rather than de jure residence status (having local *hukou*) can essentially break the barriers to social mobility.

A second proposal is to strengthen the central government's responsibility for bearing the costs of reform of the *hukou* system so as to incentivise both levels of government in pushing reform forwards. At present, there is a lack of incentive for local government in providing equal public services to migrants and in carrying out the *hukou* system reform aimed at legitimising migrants' residence status.

According to Lu and Cai (2014), the *hukou* system reform can increase the potential growth rate through raising labour supply, creating resource reallocation efficiency and expanding consumption, which increase revenues for both central and local governments. Those reform dividends, however, cannot be exclusively obtained by specific localities while local governments bear almost all the reform-related costs such as the expense of incorporating migrants into full coverage of local public services.

Given the *hukou* system reform has positive externalities to China's economic and social development, the central government taking major responsibility for financing the reform is not only the key to breaking the deadlock, but also in line with policymaking and institutional logic.

A third proposal is to transform local governments' role from promoting GDP growth to improving social development by getting the focus right on the public finance system. In an era of population ageing, individual cities can undoubtedly benefit from attracting incoming, often more productive, residents as long as the central government pays the initial costs.

Further reforms should focus on properly defining the function and boundaries of public finance, reasonably dividing revenues and expenditures between central and local governments and granting municipal governments the power, responsibility and autonomy to provide public services. This way, local governments will have appropriate motivation to compete for migrant workers and their families by providing better public services.

The link between local public service provision and labour migration and social mobility can be understood in the theoretical framework coined by Tiebout (1956) and McGuire (1974). These authors model two corresponding behaviours—that is, local governments or communities intentionally attract or expel residents by altering the type and magnitude of public goods provision, on the one hand, and potential migrants choose where they want to reside in accordance with their preference for public goods, on the other. Social mobility—horizontal and vertical—is obviously in the utility function of both behaviours.

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