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What kind of high income country can China become?**

Nazrul Islam
United Nations and ICSEAD

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Beyond the middle income trap: What kind of high income country can China become?

Nazrul Islam¹

United Nations
and
International Center for the Study of East Asian Development (ICSEAD)

Abstract

China's middle income status has given rise to the question whether it will be able to avoid the 'middle income trap.' Some authors, such as Kharas and Kohli (2011), suggest that, in order to avoid the trap, it is necessary to switch the economic development strategy after a country progresses from the low to the middle income stage. However, others, such as Lin (2012), argue that no such switch is necessary; instead countries need to pursue the Comparative Advantage Following (CAF) strategy in both the low and middle income stages. The paper provides a review of these two apparently contrasting perspectives. It notes that, despite the differences, both these perspectives agree on the necessity of a more equitable income distribution as a condition for avoiding the middle income trap. However, while the Kharas and Kohli perspective allows for redistribution, Lin thinks that equity should be achieved at the stage of functional distribution of income. The paper reviews these alternative routes to achieving equitable distribution and compares China's record regarding inequality with that of Japan, South Korea, and Taiwan Province of China. It also poses the question what China could do differently in order to emerge as a high income country with some distinctiveness.

* Nazrul Islam is a Senior Economic Affairs Officer at Department of Economic and Social Affairs of the United Nations. Previously, he taught economics at Dhaka University (Bangladesh), Harvard University (USA), Emory University (USA), and Kyushu University (Japan). He is also a Fellow (Cooperative Researcher) of the International Center for the Study of East Asian Development (ICSEAD), Kitakyushu, Japan. The paper was presented earlier at the conference on "Quest beyond the Middle Income Status: International Experience and China's Prospects," organized by Shanghai University of Finance and Economics, and held in Shanghai on July 3, 2013 and at a seminar at Department of Economic and Social Affairs of the United Nations in New York. The author would like to express his sincere thanks to the participants of the conference and the seminar for their helpful comments and suggestions. Special thanks are due to Nicole Hunt for her help in gathering data and producing the graphs. The views expressed in this paper are author's personal and may not be ascribed to any of the organizations to which he belongs. Please send your comments to nislam13@yahoo.com.

Beyond the middle income trap: What kind of high income country can China become?

Introduction

China's entry to the middle income group raises the interesting question of whether it will be able to avoid the middle income trap. Some authors, such as Kharas and Kohli (2011) suggest that, in order to avoid the trap, countries need to switch their economic development strategy after they progress from low to middle income stage. However, others, such as Lin (2012), argue that no such switch is required. Instead, countries need to pursue the Comparative Advantage Following (CAF) strategy in both the low and middle income stages. The paper provides a review of these two apparently contrasting perspectives.

Despite the differences, both the perspectives agree on the necessity of a more equitable income distribution as a condition for avoiding middle income trap. However, while the Kharas and Kohli perspective allows for redistribution, Lin thinks that equity should be achieved at the stage of functional distribution of income. The paper reviews these alternative routes for China to reduce inequality and compares China's inequality dynamics with those of Asian countries which have been successful in transiting to the high income category. It shows that while the other successful East Asian economies have by and large defied the Kuznets' hypothesis regarding the relationship between inequality and economic growth, China has let inequality to rise. However, high inequality has now created a set of problems that China has to deal with if it wants to avoid the middle income trap. In confronting the current problems, China can also follow certain policies, such as promotion of cooperative ownership and protection of environment that can impart on it a distinctive mark as it emerges as a high income country.

The paper is organized as follows. Section 1 provides the descriptive definition of middle income category. Section 2 introduces the concept of "middle income trap." Section 3 presents the two contrasting views that have emerged in the literature of the middle income trap, and identifies the points of contrast and congruence between them. One of the points of agreement is that distribution of income has to be equitable if a country wants to avoid the middle income trap. Section 4 discusses China's inequality dynamics and compares them with those of successful East Asian economies. Section 5 discusses the pros and cons for China of following the two alternative routes to reduction of inequality. Section 6 discusses the possibility of China to emerge as a high income country with some distinctiveness through pursuit of some innovative policies with regard to ownership and environment. Section 7 concludes.

1. China enters the Middle Income group

According to the World Bank's definition, the middle income category comprises of countries with per capita GNI lying between \$1,026 and \$12,475 (of 2011). Clearly, it is a very wide range, with the upper bound more than ten times greater than the lower bound. No wonder that it is the most numerous group, comprising of 88 countries and accounting for about half of the world's population. The World Bank therefore distinguishes two sub-groups, with a "lower middle income group" comprising of countries with per capita GNI between \$1,026 and \$4,035, and an "upper middle income group" comprising of countries with per capita GNI between \$4,036 and \$12,475 (all figures for 2011).¹

With a per capita income of \$5,445 in 2011 (World Bank 2012), China is in the middle income category, and already in its upper group. China's middle income status has given rise to considerable discussion. This is not surprising, given the weight of China in the world, in terms of both population and size of the economy. A question that is frequently asked is whether China will be able to avoid the "middle income trap."

2. The Middle Income Trap

The middle income trap refers to the phenomenon of stagnation of many countries in the middle income category. These countries have raised their per capita income level from low to middle income status, but have failed to progress further and reach the high income category. Many such countries are in Latin America, such as Argentina, Brazil, Chile, and Mexico. A similar situation can be seen with regard to South Africa and several countries in Asia. In contrast to these countries are the East Asian economies such as Japan, South Korea, Taiwan (Province of China), Hong Kong (Special Administrative Region of China) and Singapore, which, after reaching the middle income status, moved forward and reached the high income level (Figures 1 and 2).

Given the above contrasting historical record, it is not unexpected to raise the question whether China will be able to follow its successful East Asian neighbors or will meet the fate of middle income trap countries. To answer this question, it is first necessary to know what the reasons behind middle income trap are and how other countries have succeeded in avoiding this trap.

An interesting literature has emerged on middle income trap.² Some scholars have tried to discuss the relevant issues at a descriptive and "proximate cause" level. Others have tried to search for deeper, underlying reasons. Instead of aiming at a comprehensive review of this literature, it may be useful to look at two somewhat contrasting perspectives. One of these is provided by Kharas and Kohli (2011), and the other by Justin Lin (2012). Most of the issues pertinent to the debate surface in the course of discussion of these two perspectives.

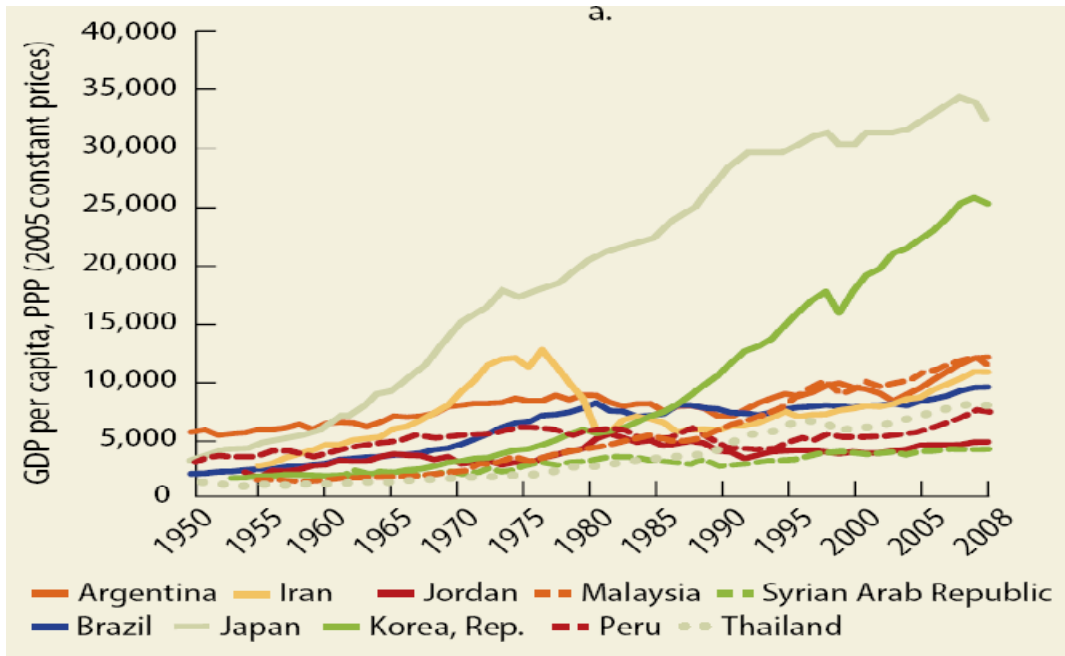
3. Different perspectives on middle income trap

3.1 Kharas and Kohli (2011)

Kharas and Kohli played an important role in popularizing the expression, "Middle Income Trap" (see Gill and Kharas 2008, Kohli and Sood 2009, and Kharas and Kohli 2011). In Kharas and Kohli (2011), the authors put forward the observation that middle income trap countries are "unable to compete with either low-wage economies or highly skilled advanced economies (p. 281)." This definition of middle income trap is clearly an advance relative to the purely *descriptive* definition noted earlier, and it reflects an attempt to find the *cause* of the trap.

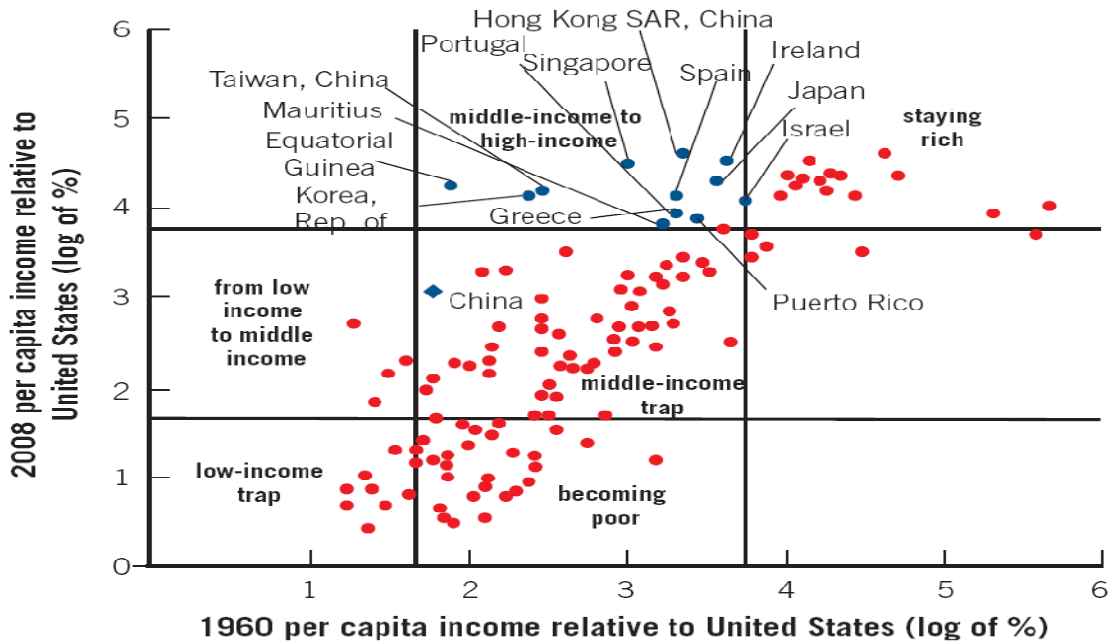
However, even this definition stays at the *proximate* cause level, and does not ask the *deeper* question of why a country fails to compete with highly skilled advanced economies. Kharas and Kohli (2011) instead move ahead to offer their suggestions about how a country can avoid the middle income trap or can come out of it if it is in it. For that purpose, they express the proximate cause in the following slightly different way. According to them, the middle income trap countries "cannot make a timely transition from resource-driven growth, with low-cost labor and capital, to productivity-driven growth (ibid, p. 282)."³

Figure 1



Source: World Bank (2012) and Hong (2013).

Figure 2



Source: World Bank 2012.

Source: World Bank (2012) and Hong (2013)

Kharas and Kohli's main suggestion is that countries need very different development strategies depending on whether they are in the low or middle income stage. In their view, it is the failure to make this switch that explains the middle income trap. The East Asian economies succeeded in making this switch, while the Latin American countries did not. According to the authors, "continuation of the very strategies that help the countries grow during their low-income stage prevents them from moving beyond the middle-income stage (ibid, p. 284)."

What do Kharas and Kohli mean by the strategy appropriate for the low income stage? Scanning their relevant statements, the following elements can be found: (i) movement of labor from less productive rural economy to more productive urban economy; (ii) transition of rural women into urban factory workers (magnifying the benefits of migration by facilitating demographic transition); (iii) employment expansion based on export of either manufacturing (as in East Asia) or modern tradable services (as in India); (iv) diversification of the economy; (v) political leadership that has to "marshal the resources of society and deploy them effectively"; (vi) "planning, organization and management, and implementation skills in both private and public sectors"; (vii) organization of the supply side.

Clearly, this list is heterogeneous. Some of them represent concrete steps, while others are desirable attributes of governance. The authors do not spell out the connections among them in order to convert them into parts of an integrated whole. However, the list may suggest that the proposed low income strategy is one of labor-intensive, resource-intensive, export-led growth that creates enough employment to draw the rural surplus labor, including female labor. This process leads to demographic transition and improvement of human capital.

However, this interpretation contradicts their statement that low income economies should build "domestic production capabilities in *most* goods and services (ibid, p. 284, emphasis added)." Also, it is doubtful that the export-oriented information technology (IT) sector of India is really drawing rural surplus labor and is of enough scope to make a significant dent in the huge unemployed and under-employed labor pool of India. Furthermore, the inclusion in this list of political leadership, planning, organization, and management, etc. is also a bit confusing, because these are required no matter whether a country is in low, middle, or high income stage.

From an analytical point of view, the most important element of this list is "focus on the supply side." As Kharas and Kohli explain, "Low-income country growth is ... principally concerned with organizing the supply side of an economy, both in terms of maximizing factor inputs and ensuring enabling policies and institutions (ibid, p. 284)." We will come back to this issue of "supply side" soon.

What kind of strategy Kharas and Kohli (2011) suggest for middle income countries? Again, scanning their relevant statements, the following may be found: (i) more capital and skill intensive manufacturing; (ii) heavier orientation toward services, in particular exportable international tradable services; (iii) more focus on demand; (iv) better income distribution; (v) modern and more agile institutions for property rights, capital markets, successful venture capital, competition; (vi) a critical mass of highly skilled people.

This is again a list, and it does not clearly spell out causal connections among its items. Moreover, the authors note that building necessary institutions is a "multigenerational effort" (ibid, p. 286). That being the case, it is difficult to see how a country can avoid a prolonged middle income trap.

Despite their somewhat amorphous presentation, it is possible to identify two particular points on which the low and middle income strategies appear to differ with some sharpness.

First, according to the authors, while the low income strategy focuses on organizing *supply*, the middle income strategy needs to focus on *demand*. The reason for this contrast is as follows. For low wage labor-intensive export, the demand elasticity is high. So a low income country does not have to worry much about demand. All that is required is organization of supply. However, after wages have increased, and a country has entered the middle income stage, it can no longer depend on labor-intensive export. It has to graduate to export of higher end products, involving innovation and product differentiation. But, the international market for such products is more demanding, and companies can only succeed if they have first tried out and succeeded in the *domestic market*. Thus, domestic *demand* is a pre-condition for success in the international market.⁴

The domestic demand issue also leads to the issue of distribution. As Kharas and Kohli (2011) note, unequal distribution of income limits the size of the domestic market and thus acts as a barrier to successful implementation of the middle income strategy. They note that some countries (particularly in Latin America) have tried to bolster domestic demand through debt financing instead of redistribution of income. However, increasing debt burden ultimately proves unsustainable and results into crises (ibid, p. 285).

The second point of sharp contrast between low-income and middle-income development strategies, according to Kharas and Kohli, concerns diversification/specialization of the economy. In their view, low income strategy should focus on diversification, while the middle income strategy should focus on specialization. The reason for specialization is that the products to be exported by middle income countries have to be more sophisticated. It is difficult for a particular middle income country to be successful across a wide range of such products. They therefore need to find their own niches and excel in them.

This proposition however begs question. It is generally in the low income stage that countries focus on a few export-oriented products (either labor-intensive, such as textile, or resource-intensive, such as minerals or agricultural commodities). The broader economy (at least its modern part) remains relatively undiversified. At the middle income stage, the economy gets more diversified, even though its export may continue to be dominated by a few particular sectors and products.

In any case, the main point of Kharas and Kohli is that a country's development strategy needs to undergo a radical switch as it moves from low to middle income stage.⁵ If a country fails to make this switch, it falls into the middle income trap. This view however sharply contrasts with the view of Lin (2012), who does not think any switch in development strategy is required.

3.2 Lin (2012) perspective

Lin (2012) provides a different perspective on reasons for middle income trap and ways to avoid it. Though focused on China, his discussion has general applicability.

According to Lin, there are basically two types of development strategy. One is the Comparative Advantage Following (CAF) strategy and the other is the Comparative Advantage Defying (CAD) strategy.

He also thinks that these two strategies lead to two different ways of addressing inequality (Lin 2012, pp. 251-254). While the CAF strategy can address inequality by ensuring more equitable functional distribution of income (i.e. distribution of the national income into income of labor and income of capital), the CAD strategy requires redistribution of income after unequal functional distribution has already taken place. The redistribution is usually done through taxes, subsidies and other fiscal instruments. Lin thinks that Latin America followed the combination of CAD and redistribution and got into the “Latin American middle income trap.”

Lin therefore recommends the Comparative Advantage Following (CAF) development strategy as a way of avoiding the middle income trap. He notes that people often think that functional distribution should not be tinkered with in order to ensure efficiency. They therefore want to address inequality through redistribution. However, Lin thinks that the goals of efficiency and equity can be combined at the stage of functional distribution, and the way to do so is to follow the CAF strategy.

3.3 Contrast between the two perspectives

The contrast between the Lin perspective and the Kharas and Kohli perspective is therefore quite obvious. Unlike the latter, Lin does not think any switch of strategy is necessary. Consistent adherence to CAF strategy will lead an economy from low to middle and then from middle to the high income stage. Lin (2012) tries to bolster his argument by claiming that all currently developed countries followed the CAF strategy, and the East Asian economies which avoided the middle income trap did so because they also followed the CAF strategy.⁶

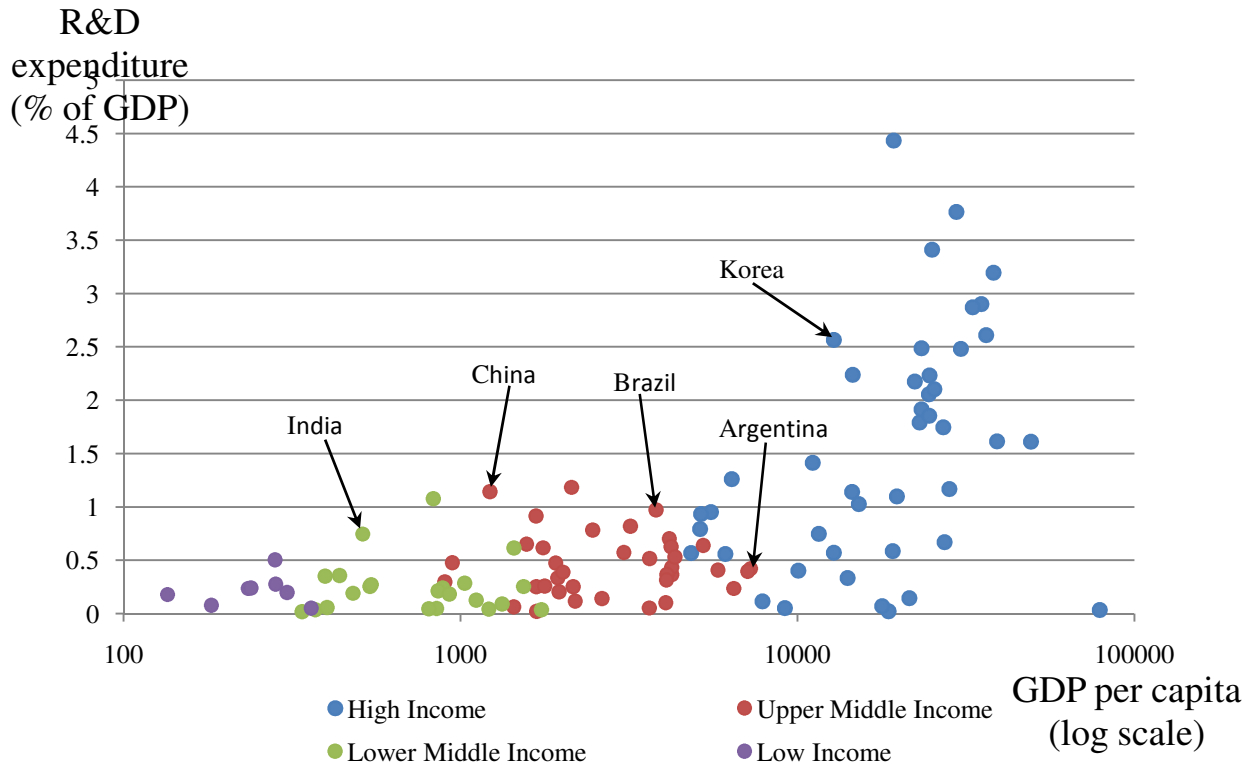
Drawing concrete implications of his suggestion for China, Lin shows that for a labor surplus country like China, CAF strategy will imply promotion of labor intensive sectors, leading to expansion of employment and hence more labor income. According to his analysis, China’s rapid growth since 1978 has been possible mainly because China abandoned the earlier CAD strategy and groped to the CAF strategy through opening up (to external market) and domestic liberalization. This allowed China to become the workshop of the world in production of labor-intensive manufacturing products. The expansion of employment led to increase in labor income. The process also leads to capital accumulation, and, with population growth rate under control, will eventually convert labor into a scarce factor and capital an abundant factor. As a result of these changes in the factor endowment structure, wages will increase and return to capital will fall, leading again to a more equitable functional distribution of income. The altered endowment structure will also move the country to a different industrial structure that will be more capital intensive, and the country will graduate to the high income category. Thus no policy shift is required.

Another fundamental difference between the two perspectives concerns the role of the state in the economy. While Kharas and Kohli perspective allows for government intervention, the Lin perspective is anti-interventionist.

By arguing for a switch in development strategy as a way to avoid middle income trap, Kharas and Kohli open up the space for an important role for the government. Their discussion points to three areas for this role. The first is redistribution aimed at reduction of inequality, expansion of the middle class, and increase in domestic demand. The second is identification of specific industries in which the middle income country should specialize. The third is R&D and building “a critical mass of highly skilled people.”

Spending on R&D indeed appears to be correlated with success in graduating from middle to high income category (Figure 3).

Figure 3



Source: Keun Lee (2013), CDP presentation and Hong (2013)

By contrast, Lin’s perspective discourages government intervention. In fact, his advocacy of the CAF strategy is in a sense advocacy of the free market approach, arguing that a country should follow what the world market would want it to produce based on its current factor endowment structure. It is therefore not surprising that almost all of Lin’s practical policy suggestions for current China are aimed at further removal of hindrances to the operation of the market.

For example, he recommends that the large SOEs should be allowed to relieve themselves of the policy burden, including those arising from social responsibilities imposed on them. This will allow SOEs to operate in the market on a competitive basis, with profit as the sole motive, and subject to hard budget constraint and market discipline (pp. 192-201). He calls for competitive recruitment of SOE managers.

Similarly, Lin recommends more competition in the banking sector and freeing up of the interest rate. He thinks that a commercial banking system based on four large national banks is not appropriate for China’s current stage of development. Such an oligopolistic banking structure, in his view, is appropriate for developed capitalist countries. In his view, China currently needs many regional, medium sized banks which will lend more to small and medium sized enterprises (SMEs), which are the main source of

China's employment growth. Lin thinks that the current state-owned, oligopolistic banking structure is leading to misallocation of capital, as more capital is directed to large SOEs, which are less efficient. He thinks that one reason why the Chinese stock markets are not proving efficient is domination of these markets by SOEs, which do not make profit and hence cannot distribute dividends, prompting the stock market to depend on gains from speculation.⁷ Lin also sees a connection between SOEs and corruption.

In similar vein, Lin draws attention to under-pricing of natural resources (largely to benefit SOEs). He notices that such under-pricing is both exacerbating inequality (creating billionaires who exploit price arbitrage) and harming environment. Correction of resource prices in particular and removal of distortions in general will lead to better environmental outcomes. He also suggests breaking up of monopolies and strengthening regulation where monopolies cannot be avoided.

The above is not to mean that Lin does not see any role of the state in economic development. However, he sees this role mostly in facilitating exploitation of the existing comparative advantage, based on its current endowment structure.⁸

Lin's perspective has the elegance of monism. Unlike Kharas and Kohli, he does not put forward a list of items without specifying their interconnections. Instead, he tries to derive all his suggestions from one underlying proposition, namely the CAF strategy. However, his perspective generates a lot of questions too.

3.4 Some issues with the Lin perspective

There have been many criticisms of Lin's views. In particular, Ha Joon Chang has debated Lin's views directly (see Lin and Chang (2009)). In contrast with Lin, Chang has the view that "a country needs to defy its comparative advantage to upgrade its industry (ibid, p. 489)." This is almost opposite to what Lin advocates. To be accurate, Lin agrees that a country needs to upgrade its industrial structure, and the government has to play a facilitating role. However, he is against deviating too far from the existing comparative advantage, though he concedes *small* comparative advantage *conforming* moves.

Lin's faith in almost *automatic* progress in upgrading the industrial structure and moving from middle to high income category finds reflection in his frequent reference to the large per capita income gap between China and the USA as the proof that it is possible for China to grow at 8 percent for another twenty years.⁹ In his view, this income gap shows that huge opportunities to borrow technologies still exist, and China can enjoy fast growth based on these borrowed technologies, if only it followed the CAF strategy. He does not show much concern about the difficulties that may lie in successfully borrowing and utilizing the technologies. However, he contradicts himself observing elsewhere that "except for a couple of core technologies that developed countries are reluctant to share, China has mastered all the other technologies (p. 141)." This would suggest that the remaining set of opportunities for borrowing technologies is not that large.

Similarly, while focusing all his policy recommendations on removal of hindrances to free market operation, Lin at a different place contradicts himself by commenting that "the gradual reform brought China closer and closer to the market economy – *in some ways closer even than some market economy countries* (p. 186, emphasis added)." This would suggest that gains to be obtained from further liberalization of the market are limited. Also, while suggesting that mere adoption of economic policies,

such a CAF strategy, will do the trick, elsewhere he contradicts himself by announcing that “many non-economic factors will decide whether China can realize its full potential (p. 17).”

An important assumption of Lin’s theory is that labor is cheap and capital is expensive at the low income stage. As per his theory, success in labor-intensive industrialization will gradually make labor expensive and capital cheap. The altered factor endowment structure will automatically lead to a different industrial structure. This smooth scenario ignores, among other, the important fact that in today’s globalized economy, capital is more mobile than labor, so that, even for a low income country, capital may not be as expensive as would have been the case in a closed economy. That being the case, the whole basis of the automatic industrial upgrading process (in response to changed relative factor price ratio), on which Lin’s theory rests, appears to be weaker than it would be in case of closed economies. Thus, much more effort is required than just leaving things to the automatic working of the market, either global or domestic. In fact, the discussion of Kharas and Kohli may be viewed as an attempt to spell out the concrete forms of this effort. From this point of view, the contrast between the Kharas and Kohli perspective and that of Lin may be more apparent than real.

Furthermore, both the perspectives agree that one of the areas in which efforts need to be directed is ensuring equitable distribution of income.

4. China’s inequality problem

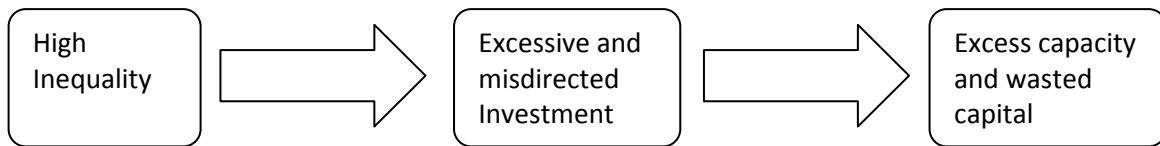
We already noticed Kharas and Kohli’s arguments for income equality as a condition for avoiding middle income trap. According to them, income equality is necessary in order to expand the middle class, enlarge the domestic market, so that firms can try out their products in the domestic market before venturing abroad. They put emphasis on redistribution as a mechanism to ensure equity.

Lin too worries about rising inequality in China. He notices that China’s Gini Coefficient has increased from 0.31 in 1981 to 0.42 in 2005, equaling or exceeding the level of inequality observed in Latin America, and higher than what is considered internationally as the safe line. He cites Confucius dictum that “inequality is worse than scarcity,” and worries that inequality may cause tensions, “bitter resentment among low-income groups,” “undermining social harmony and stability” (ibid, p. 17).

An important dimension of China’s inequality is rural-urban inequality (see Ramstetter, Dai, and Sakamoto 2009 for a discussion of different dimensions of inequality in China). In the initial years after reform (during 1978-1984), rural income grew faster than urban, reducing rural-urban inequality. However since then rural income growth has lagged behind, increasing the rural-urban gap. The current urban-rural income ratio in China is 3.3:1, one of the highest in the world. Despite some recent measures to counteract, this trend has not yet been reversed, and based on historical growth differential since 1998 (4.5 pct for rural and 8 to 9 pct for urban), this ratio is to increase to 4.9:1 by 2020. Lin finds it “unimaginable” (Lin 2012, pp. 164-165). According to him, with such high inequality “social tensions will be so acute that a harmonious society will be out of the question (ibid, pp. 238-9).”¹⁰

Lin identifies three problems of current China, namely (i) excessive investment and insufficient consumption, (ii) excessive money supply and credit, and (iii) excessive trade supply (meaning export). He thinks that the root of the problem lies in excessive investment, which causes excess capacity (ibid, p.

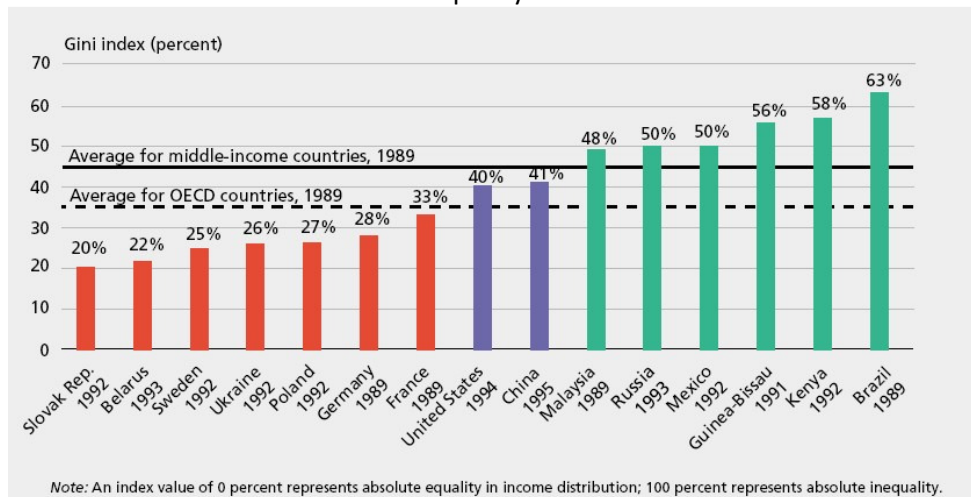
247). However, excessive investment, in turn, is a consequence, to a large extent, of unequal distribution of income. The causality, as per this analysis, therefore flows as follows:



Inequality is leading to lopsided allocation of GDP, with very high share of investment, causing excess capacity. Thus, Lin thinks that the Chinese government’s measures to restrain investment and cool down the economy have failed because “the government failed to take radical action to tackle the *cause, the increasingly inequitable distribution of income* in recent years (p. 247, emphasis added).” Lin notes that in addition to the rural-urban, inequality is increasing within cities too.

Transition from one of the most egalitarian societies in the world to one of the more inegalitarian societies is one of the most dramatic features of China’s recent growth and transformation. Inequality in China is now greater than in the USA (Figure 4).

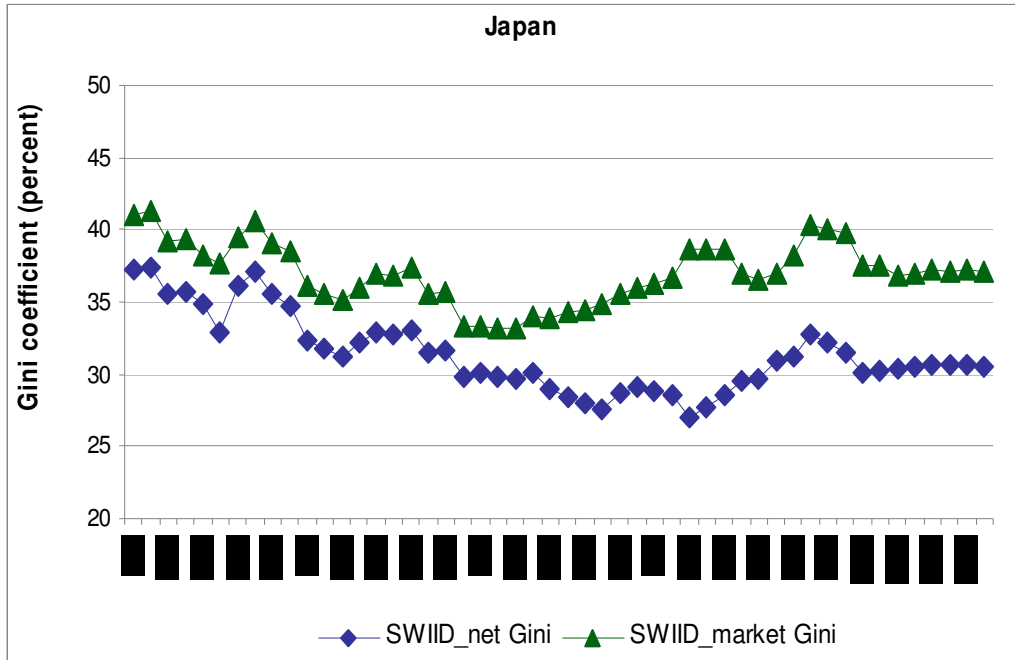
Figure 4
Variation in inequality across countries



China’s experience with inequality differs from that of the East Asian economies that succeeded in transiting from the middle to the high income category. This can be seen from Figures 5, 6, 7, 8, and 9 that present inequality dynamics in Japan, Taiwan POC, South Korea, Hong Kong SAR, and Singapore, respectively. Inequality is measured by the Gini Coefficient of distribution of both “gross” (or market) income and “net” income (or disposable income obtained after taxes and transfers). For easy reference, the Gini Coefficient of the former is referred to as “market Gini,” while that of the latter as “net Gini.” The difference between the two reflects the impact of redistribution on income inequality. The graphs are based on the inequality dataset put together by Solt, building on previous inequality data gathering

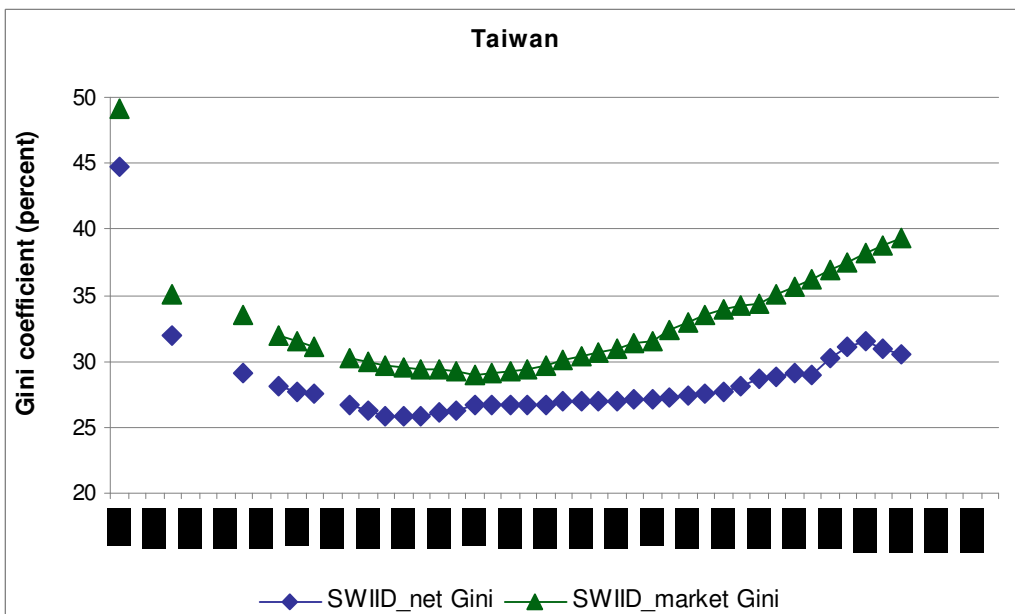
efforts by the OECD, the World Bank, and the UNU WIDER. It is known as the “Standard World Income Inequality Dataset (SWIID),” and Solt (2009) provides the details regarding this data set.

Figure 5: Inequality dynamics in Japan



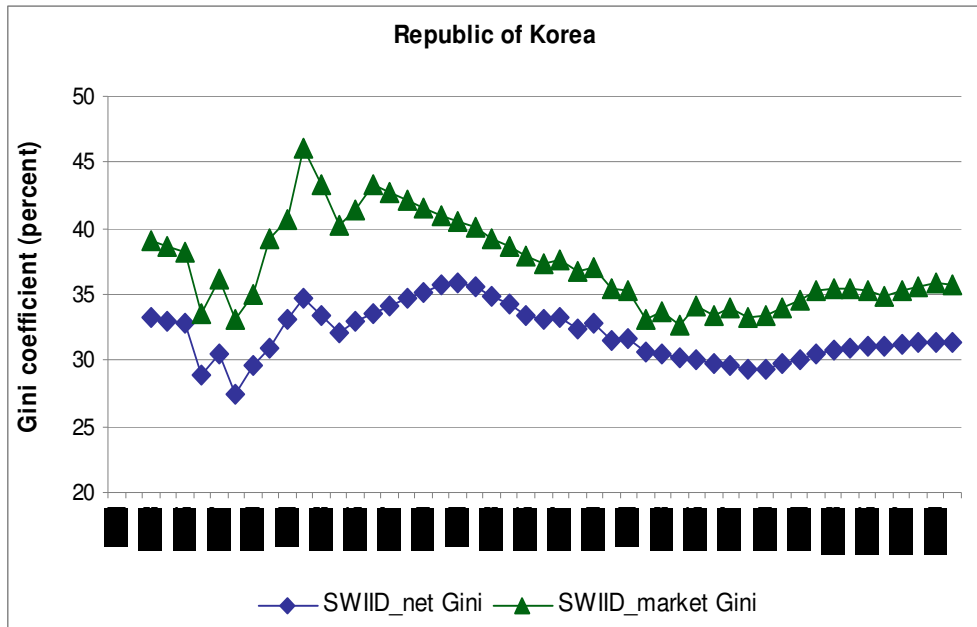
Note: Computed on the basis of data provided in the Standardized World Income Inequality Database (SWIID) Version 3.1, released December 2011. For description of the data, see Solt (2009).

Figure 6: Inequality dynamics in Taiwan



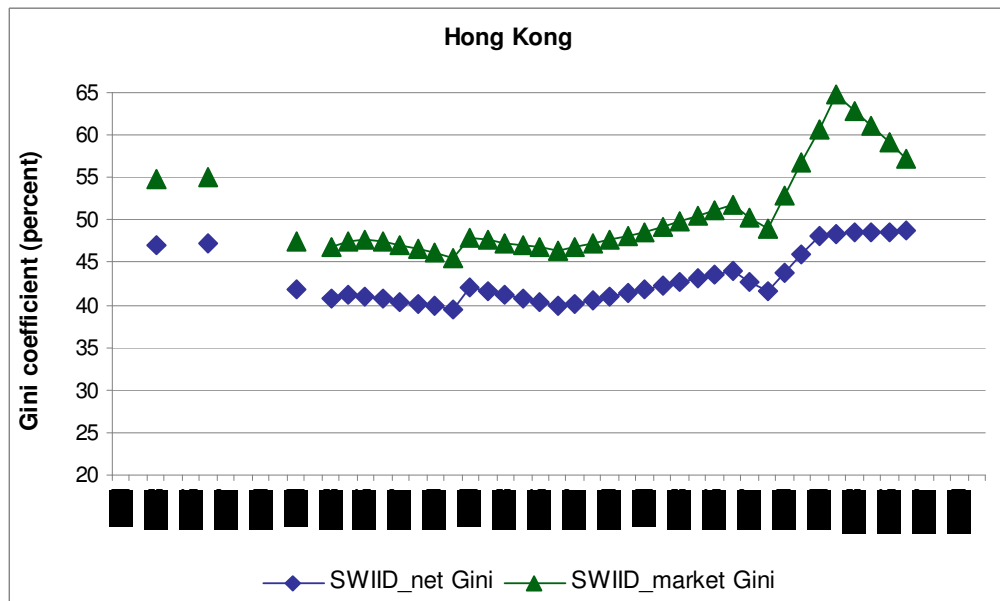
Note: Computed on the basis of data provided in the Standardized World Income Inequality Database (SWIID) Version 3.1, released December 2011. For description of the data, see Solt (2009).

Figure 7: Inequality dynamics in South Korea



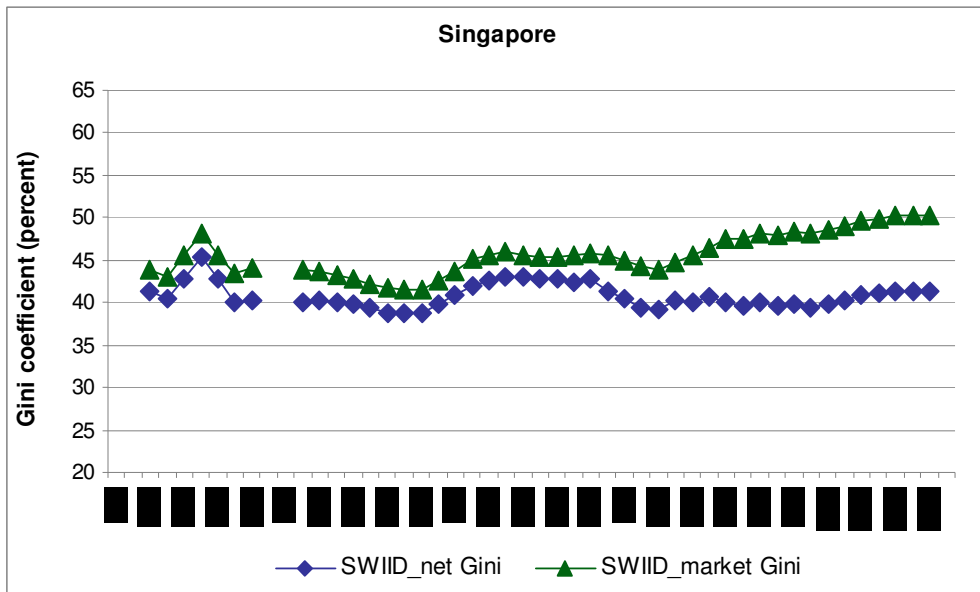
Note: Computed on the basis of data provided in the Standardized World Income Inequality Database (SWIID) Version 3.1, released December 2011. For description of the data, see Solt (2009).

Figure 8: Inequality dynamics in Hong Kong, SAR



Note: Computed on the basis of data provided in the Standardized World Income Inequality Database (SWIID) Version 3.1, released December 2011. For description of the data, see Solt (2009).

Figure 9: Inequality dynamics in Singapore



Note: Computed on the basis of data provided in the Standardized World Income Inequality Database (SWIID) Version 3.1, released December 2011. For description of the data, see Solt (2009).

Looking at Figure 5, we see that inequality in Japan actually decreased during its growth spurt (1960s and 1970s), despite some bumps along the way. The net Gini fell below 30 pct. Though inequality has since increased, the net Gini still remains close to 30 percent. Thus, Japan defied the Kuznets hypothesis regarding relationship between inequality and economic development of a country. According to this hypothesis, inequality is expected to increase initially with economic growth and decrease only later, implying an inverted U-shaped curve when the relationship is plotted with income level on the x-axis and measures of inequality on the y-axis (as in Figures 5-9), where years proxy for the income level. Instead of the Kuznets' pattern, Japan displayed an opposite, a mild U-shaped, pattern.

The experience of Taiwan PoC has been similar to that of Japan (Figure 6). During its growth spurt, inequality in Taiwan PoC decreased, with the net Gini falling below 26 percent. It remained close to that low level for quite some time, and only in recent years it has experienced some increase, though still remaining less than 32 percent. Thus we find again a mild U-shaped pattern, instead of Kuznets' inverted U.

In case of South Korea, we see that inequality fluctuated during the initial years (1965-1981) of the growth spurt (Figure 7). In fact, one may want to see an inverted-U shaped pattern for this period. However, the net Gini never crossed 36 percent, and since 1981 inequality in South Korea has decreased and the net Gini fell below 30 percent during 1996-2000. Since 2000, net Gini in South Korea has experienced mild increase, though it still remains very close to the 30 percent mark. Thus, leaving aside the initial episode, South Korea too defied the Kuznets hypothesis.

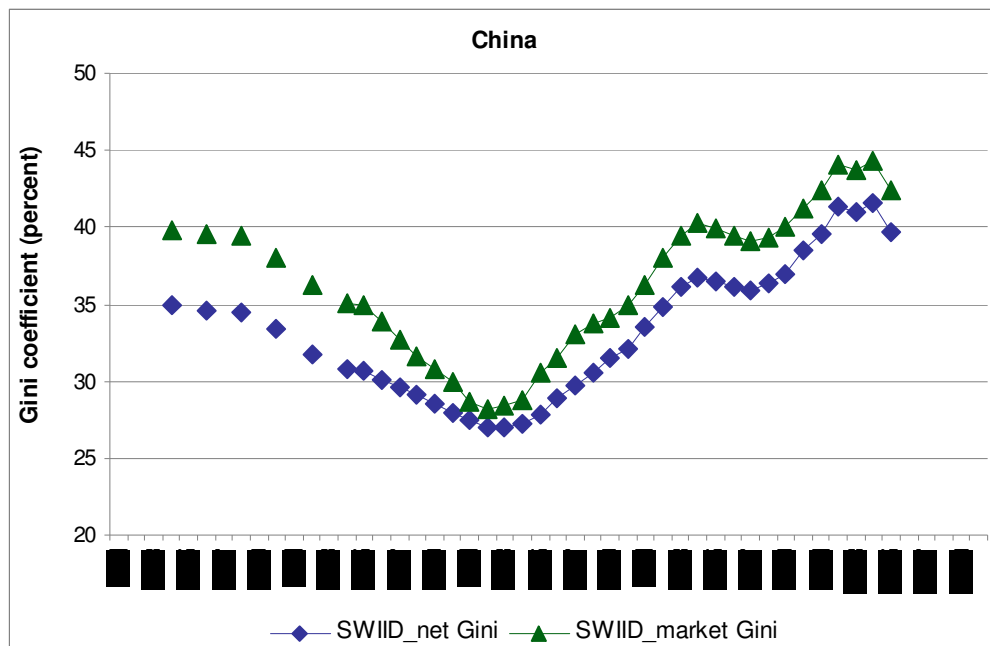
Hong Kong SAR and Singapore, being entirely city states, are not that comparable with China and the other East Asian economies discussed above. All the latter economies started off as predominantly rural and agricultural, and their industrialization involved urbanization and rural-urban migration. However,

even in case of Hong Kong SAR and Singapore, we see departure from the Kuznets pattern. Though these economies began with relatively high levels of inequality, they also managed to prevent inequality from rising too much during their growth spurts.

Thus we see that all East Asian economies that were successful in avoiding the middle income trap prevented inequality from rising (or at least rising too high) during their periods of growth spurt. Many of them in fact were able to reduce inequality. It is this combination of growth with equality that became the hallmark of East Asian growth model.

We may now compare China’s inequality dynamics (Figure 10) with those of the East Asian economies discussed above. We see that there are differences in both pattern and level. With regard to pattern, as noted earlier, inequality in China decreased during the agricultural reform years of 1978-1983. However, since 1984, when the industrial reform began, inequality in China increased steadily, with the market Gini reaching almost 45 percent. Since 2002 inequality has started to decrease, and if this trend holds, China’s inequality dynamics since 1984 will conform to the Kuznets hypothesis, departing from the East Asian model. With regard to level, despite the recent decline, inequality in China still remains high, with net Gini above 40 percent, which is internationally considered to be a level that separates countries with high income inequality from the rest. As we saw above, in none of the non-city state East Asian successful economies inequality ever reached that high level.

Figure 10: Inequality dynamics in China



Note: Computed on the basis of data provided in the Standardized World Income Inequality Database (SWIID) Version 3.1, released December 2011. For description of the data, see Solt (2009).

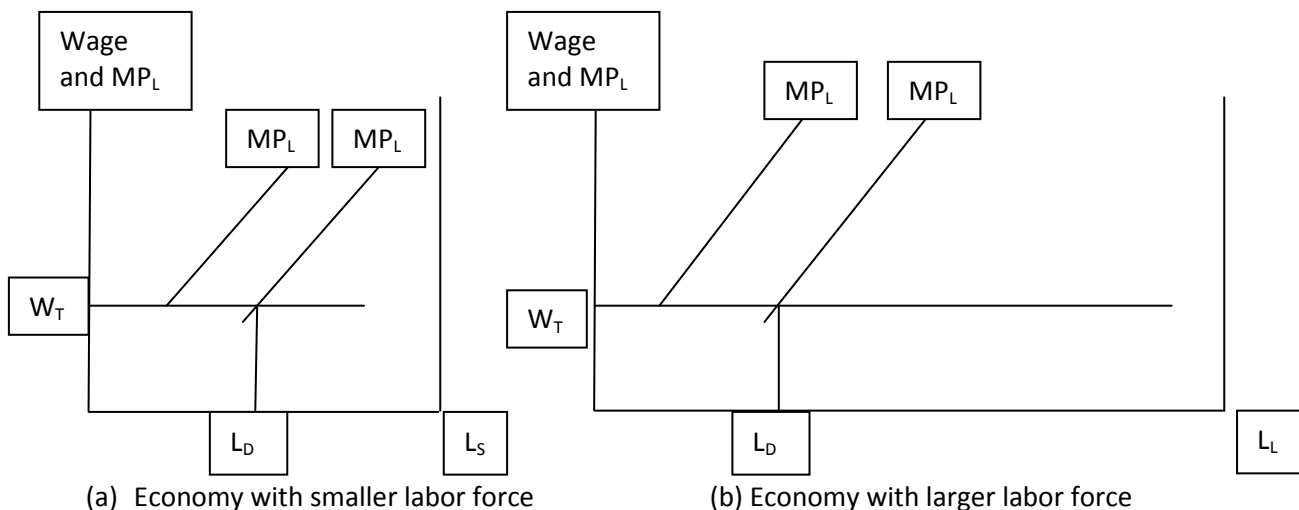
This contrasting experience leads to the following questions. Why did inequality in China reach such a high level? Was such a high level of inequality necessary for China’s recent growth? Will inequality lead China to the middle income trap? What can China do to reduce inequality at a sufficiently fast pace?

Finally, can China do things differently so that it not only avoids the middle income trap but emerges as a high income country with some distinctiveness?

With regard to the first question, it is clear that the combination of market forces and private entrepreneurship played the main role in creating and exacerbating social inequality (See Islam 2009 and Ramstetter, Dai, and Sakamoto 2009 for further discussion of China’s inequality.) Aggravation of regional and urban-rural inequality has additional reasons. However, the combination of market forces and private entrepreneurship was also true for other successful East Asian economies’ growth spurt too. Why then inequality increased so steeply in China while it did not do so in these other economies? Can the difference in size (of population or labor force) help explain the difference in inequality dynamics?

Viewed from the Lewis perspective, an economy with a larger traditional sector has the potential to generate a larger volume of surplus (profit) as a result of transfer of labor from the low productivity traditional sectors to the high productivity modern sectors. Figure 11 provides an impressionistic presentation of this potential, with L_S and L_L as the size of labor force of a small and large economy, respectively, W_T as the wage rate in the traditional sector, MP_L as the schedule of marginal product of labor in the modern sector, and L_D is the point showing the division of the labor force between the traditional and modern sectors. Clearly, if the wage remains constant at W_T , as the Lewis model assumes, then a much larger volume of surplus (profit income) will be generated in the larger economy, and if concentrated in a few hands, this may lead to greater inequality in the larger economy. However, much depends on the wage level in modern sectors and also on the distribution of surplus created in the modern sectors. For example, in terms of size (of the labor force), Japan is much bigger than Taiwan POC, and yet we see that inequality dynamics in these two economies during their growth spurts followed similar pattern. Thus size difference alone cannot answer the question.

Figure 11: Large and Small Sized Economies Undergoing the Lewis Growth Process



Was high inequality necessary for China’s fast growth? The standard justification for higher inequality is that it leads to more savings (by the rich), and hence more investment and faster growth. Sometimes Rostow’s theory regarding stages of growth, Lewis model of growth, or Harrod-Domar model (with fixed

capital coefficient) are cited in support of this argument. However, the propensity to save may be high even among low income families, and this proposition seems to be particularly true for China (and India too) (Islam 2009). Second, an efficient financial system can mobilize small savings of many and make it available for investment. In fact, China has been quite successful in such financial intermediation (Lu 2009). In particular, during the initial years of reform it could mobilize rural savings through Rural Credit Cooperatives (RCC) and other financial institutions and make them available for investment elsewhere in the economy (see McKinnon 1994 for details). Similarly, in Japan the Postal Service played an effective role in collecting small savings of both rural and urban population and making them available for investment. In fact, effective mobilization of small savings through the postal service has been an important reason why Japan's growth spurt did not require high inequality. In fact, this method of financing growth allowed wider diffusion of profit/interest income, helping to keep inequality in check and even to reduce it.

Thus, it is difficult to say that a very high degree of inequality was necessary for China's recent growth. In fact, it may be argued that China could have avoided the current problems of economic imbalance, investment inefficiency, social discontent, etc. had it put more emphasis on equitable distribution of income and pursued the small savings route to industrialization.

The current real estate bubble (which may be called the "apartment bubble," to distinguish from the "housing bubble" of the USA) of China can help illustrate the point.¹¹ Millions of apartments constructed in recent years remain vacant, because ordinary Chinese citizens lack the income to buy them. At the other end, affluent Chinese have the income to buy multiple apartments, and they are indeed doing so, but only with the purpose of gaining from apartment price appreciation.¹² The speculative demand has often led to construction of wrong type of apartments and at wrong places. For example, more high priced, luxury apartments have been built, and they have been built in places far removed from centers of work opportunities for ordinary citizens, who cannot yet afford private cars to commute to work. Such distant location of apartment complexes is also not helpful from the viewpoint of resource conservation and environmental sustainability.

Of course, inequality is not the only cause for the Chinese apartment-bubble and the danger it now poses. Additional reasons include misdirected investment pushed by local governments, easy access by them to credit from publicly owned banks, collusion between local government authorities and developers, etc. Another cause behind the real estate bubble is land availability. Since land is under state ownership, it is easy for local governments to confiscate land and hand it over to developers at no or low cost. Easy availability of land has also been a reason why construction in China has often acquired a sprawling character, leading to waste of both land and material resources, and causing long term harm to environment and sustainability.

While all the above reasons are important, there is no denying of the fact that inequality has a central role in the current predicament that China faces. The legacy of *Hukou* itself is a central fact of inequity pervading the Chinese society. For example, the *Hokou* system does not allow more than a hundred million migrants to settle permanently and buy apartment (if they can afford) in the cities in which they live and work. Thus China has an apartment bubble when the housing needs of an important part of its population remains unmet.

Thus on the whole, it is possible to conclude that such high levels of inequality as currently observed were not necessary for China's growth. Instead the inequality has often been a cause of imbalance in the economy, over and misdirected investment, and the resulting capital waste. In order to overcome these

problems, China has to address the issue of inequality. This brings us to the last two questions raised above, namely what China can do to reduce inequality and whether can China do things differently so that it not only avoids the middle income trap but emerges as a high income country with some distinctiveness. We discuss these two questions in the following two sections.

5. Different ways to address inequality

5.1 Improvement of the functional distribution of income

We noticed earlier Lin's emphasis on the distinction between addressing inequality through improvement in the functional distribution of income and through redistribution. These two routes may also be referred to as the "direct" and "indirect" routes. For easy understanding, imbalance in the economy, the first may also be referred as the "wage route," though this involves some simplification (See Islam 2009 for discussion.)

China's dilemma with regard to wage increase is understandable. There is the worry that wage increase may lead to loss of competitiveness in the global market, harming the process of industrialization. As Islam and Yokota (2009) show, China is moving towards the Lewis Turning Point, and there are some reflections of this process in labor shortages and wage increases reported in some of the coastal cities. However, China is a large country with substantial formal and informal restrictions still holding on labor migration. Thus, the reported labor shortages and wage increases do not mean that China as a whole has yet crossed the Turning Point. In fact, the worry is that premature wage increase may abort the Lewis process.

Another dilemma in this context arises from China's commitment to market reforms. This commitment may make China reluctant to intervene in the labor market and influence wage setting. However, commitment to *laissez faire* policy also implies freedom for the Chinese workers to form trade unions and engage in collective bargaining regarding wage and benefits.

As noticed above, a large pool of unemployed and under-employed labor still exists in China. According to Fan (2005), a total of 300 to 400 million people in China need to be relocated to non-farming sectors in the next 40 to 50 years. Li (2012) also repeatedly draws attention to huge pool of unemployed and under-employed labor remaining in the Chinese countryside. In such a "labor-surplus" situation, it is difficult to see how wages of unskilled labor can increase appreciably through the workings of the market itself.

However, these dilemmas do not mean that China should feel paralyzed regarding moving along the wage route. For example, China may pay more attention to upgrading the quality of her labor force (through more education and training), and thus climb up the ladder of skill intensity of commodities produced, so that wages can increase while not undermining export. In fact, it is to this type of efforts that Kharas and Kohli were pointing.

It is generally agreed that after enjoying three decades of export-led growth, Chinese economy now needs to reorient more towards domestic demand. However, robust domestic demand requires equitable distribution of income, showing that the latter is necessary for sustaining China's growth in the future. Domestic demand can arise from three sources, namely household consumption, investment, and government purchase. China's experience shows that a lopsided distribution of demand

between consumption and investment ultimately surfaces as a constraint on the growth process itself. Thus boosting domestic consumption demand through wage growth is necessary even if it means loss of global competitiveness in the production of some labor intensive products.

Wage growth through collective bargaining also requires abolition of the remaining *Hukou* restrictions to allow migrant workers a permanent footing in the cities in which they work. Without such a footing it is difficult for them to organize and bargain. China appears to have a 'love-hate' relationship with migrants. It cannot do without them. At the same time, it is not embracing them fully, continuing to deprive them from formal residence in cities and from access to various social services (including housing, education, and healthcare) and public utilities that go with the resident status. China needs to find a solution to this conundrum soon, because the phase of enjoying migrants' labor without giving them adequate rights cannot go on forever (Islam 2009, pp. 10-11).

Abolition of *Hukou* may lead to further increase in the number of migrants and depress their wages in the short run. Also, it has to proceed step-by-step, dovetailing the dispersed urbanization strategy that China may like to follow (Islam 2009). However, full integration of the Chinese urban and rural labor market and ending discrimination regarding residency rights have become urgent, for both economic and socio-political reasons. The integration is necessary to boost domestic demand, rebalance the economy, pave the way for resolution of the "apartment bubble," ensure a "soft landing," put the Chinese economy on a sustainable robust growth path, and lead it away from the middle income trap.

Thus, much can be done along the wage-route to address China's inequality problem, and in the long run, this route has to be the dominant one. However, in view of the limitations and dilemmas above, it is necessary to consider the redistribution route too. What is therefore needed is a combination of the wage route and the redistributive route. For example, full realization of the benefits of abolition of the *Hukou* system is not possible without such a combination.

5.2 The redistributive route

We noticed earlier Lin's caution against redistribution and his advocacy for improvement of the functional distribution as a way to address the equity issue. Will his recommended policies change the functional distribution of income in such a significant way as to reduce Chinese inequality significantly?

Lin does not provide any quantitative evidence to support his claim. At a qualitative level, he may argue that directing more credit toward SMEs (instead of capital intensive SOEs) will lead to more expansion of employment. How much net increase in labor income this will bring about depends to a large extent on the opportunity cost of the labor employed. Second, the process will also lead to profit income. The net effect on inequality is therefore uncertain. Unless the wage/profit ratio in the incremental employment is greater than at the base level, the functional distribution will not be more equal. This shows again that increasing the wage/profit ratio is important. However, in view of the wage-route dilemmas noticed above, indirect, redistributive measures (using instruments of public finance) may have more appeal in current China as a mechanism for mitigating income inequality.

It is well known that China's market oriented reforms were accompanied by significant withdrawal of the state from provision of various public services, including those related with education and health. This withdrawal has been particularly noticeable in rural areas, where abolition of the Communes also meant the end of the public services that these provided. Similarly public services are absent or lacking

for the more than a hundred million of migrants who work and live in cities without registration rights. Thus the task of abolition of the *Hukou* system is related with the tasks of building a universal social security system (including unemployment and pension benefits) and a system of provision of essential public services, including education and healthcare. China cannot hope to graduate to the high income category unless these essential tasks are accomplished.

It is one of the empirical regularities of development that the role of redistribution increases as the economy gets richer. In fact, increased role of redistribution is one of the channels through which the Kuznets hypothesis of reduction of inequality at higher stage of development works. Greater role of redistribution with time has been true for the Western developed countries, where Dickensian capitalism gradually transmuted into varieties of welfare capitalism. In many of these countries, more than 50 percent of the national income is now collected by the government to be spent for various public purposes, including transfers to people whose earned income is low.

This regularity seems to have been true for East Asian developed economies too. Looking at Figures 5-10, we see that the vertical distance between the market Gini and net Gini curves has increased for almost all the economies. The increase is particularly prominent for Japan, Taiwan POC, and Singapore. In case of South Korea, significant distribution seems to have been practiced at a very early stage of the growth spurt, and that might have been one reason why the tendency of the net Gini to increase could be reversed. The experience of these economies therefore show the route China needs to take if she wants to emulate their success in avoiding the middle income trap and graduate to the high income category.

In his discussion, Lin notices that China's tax rate is already high. That being the case, significant problems must lie in tax collection, because otherwise it is difficult to reconcile high tax rates with high inequality as reflected in high Gini coefficients. Thus China may need to address issues of both tax rates and enforcement of the rates. Installation of an effective tax system is another task that needs to be accomplished in tandem with the tasks of building an effective social security system and a system of public service delivery.

Thus, China needs to proceed along both the wage route and the redistributive route to reduce inequality and build effective tax, social security, and public service delivery system in order to create the necessary conditions for avoiding the middle income trap and move to the high income category. The interesting question is whether China can accomplish these tasks in a way that can make it a high income country of a different kind.

6. What kind of high income country can China become?

There seems to be two important ways in which China can distinguish itself as it strives to reach the high income status. The first is through promotion of cooperative ownership and the second is through being more environment-friendly.

6.1 Enhanced role of cooperative ownership?

China is uniquely placed to use the cooperative route to less inequality. Cooperatives allow the members to benefit not only from wages, but also from profit. Of course, distribution of shares among employees of joint stock companies is one way of sharing profit. However, unlike joint-stock companies,

where shareholders may not also be the employees and employees may not be shareholders, in a cooperative all employees are also shareholders. Thus, profit sharing has a more potent role in a cooperative.

China has a rich tradition of cooperative effort and enterprise. Apart from the cooperative efforts of the pre-reform years, China witnessed the explosion of Township Village Enterprises (TVEs) following the reform. In a few years, TVEs were employing about 125 million rural workers and accounted for about 42 percent of China's industrial output and 35 percent of export in 1994. It is true that many TVEs were actually owned by private individuals, who were wearing "red hat," i.e. registering their enterprises as cooperatives because outright private enterprise was still not allowed or was frowned upon. Similarly, cooperatives flourished in Chinese cities when on October 17, 1981, the CPC Central Committee and the State Council issued *Several Decisions on Opening up the Door, Enlivening the Economy, and Solving Employment Problems in Cities and Towns*, allowing "individual economy" as a "necessary complement" to the socialist collective economy (Coase and Wang 2013). These individual economies were not allowed to hire more than seven workers. Enterprises aspiring higher scale of operation therefore had to take the form of cooperatives, which were already allowed under "street committees." Again, it is true that many of these cooperatives were also examples of wearing "red hat" for convenience. However, it remains a fact that there were significant traditions of cooperative enterprise in both rural and urban China in not too distant past.

One way to mitigate inequality in China may therefore be to revive and encourage cooperative forms of ownership. For this to happen, state backing will be necessary, because a particular form of ownership cannot take root and expand without state support. For example, one reason why most of the apartment buildings in New York City are under (at least formally) cooperative ownership is the tax break that this form of housing ownership enjoys from the New York state. As China grapples with the huge issue of inequality that has built up over the last three decades, it may consider whether it can use the cooperative route along with the wage route and redistribution route. The fact that the banking sector in China is still largely under public ownership means that the government has significant leverage over the economy, and it can use this leverage to promote cooperative ownership provided it is found effective in producing output and reducing inequality. A significant presence of successful cooperative ownership can then make China a different kind of high income country.

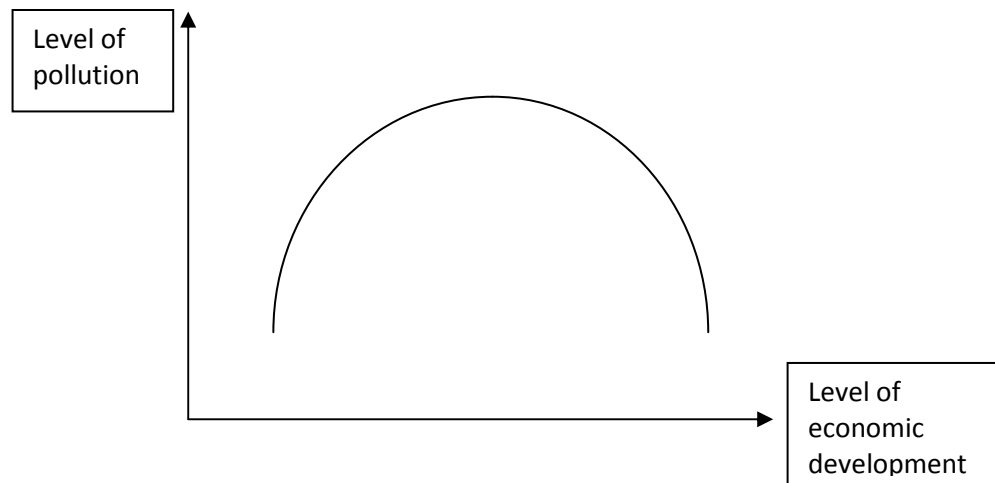
6.2 Greater emphasis on environmental protection

Another way China can emerge as a developed country with certain distinctiveness is through giving more emphasis on protection of environment early on and not waiting till it reaches a high level of per capita income.

Drawing a parallel with the Kuznets' inverted-U shaped curve regarding the relationship between inequality and level of economic development, often an Environmental Kuznets' Curve (EKC) is also put forward (Figure 12). According to this proposition, pollution will increase initially with economic growth and will decrease only later. The western developed countries did in fact follow an EKC pattern, letting pollution to increase first and then making efforts to curb it. Among East Asian developed countries, Japan also followed a similar route. However, spread of environmental awareness and availability of pollution reducing technologies have now made it possible for developing countries to defy the EKC and achieve economic growth without or with much less environmental degradation (see Islam, Vincent, and Panayotou 1997, and Islam 1997). In fact, the Greenfield aspect of their infrastructure development

allow developing countries often to leapfrog to more environment-friendly technologies and patterns of production and settlement bypassing the polluting phases that the currently developed countries had to cross.

Figure 12: Environmental Kuznets Curve



China is in a unique position to make use of these opportunities to confront both local and global environmental problems. As noted earlier, China plans to move another 300 to 400 million people from rural to urban areas. This will obviously require a huge amount of new infrastructure building. In doing so, China can leapfrog and adopt most environment-friendly settlement patterns, conserving energy and resource use.

China is aware of these opportunities and is trying to make use of them. Its initiative to construct entirely new eco-friendly cities is one example of this effort. China has also become the world leader in the production of solar panels and wind turbines. By adopting these renewable and pollution free electricity generation technologies at home and supplying them at low cost to the rest of the world, China is playing an important role in climate change mitigation. China has also made significant efforts to increase its forest cover.

These achievements and potential suggest that China can defy the EKC and can become a leader in resolving both local and global environmental problems. This early success in dealing with environmental problems can become another distinctive mark of China as a high income country.

Conclusions

Now that China has reached the upper middle income group, many have asked the question whether it will be able to continue its progress and reach the high income category or fall into the “middle income trap.” This paper begins by examining different perspectives that researchers have offered with regard to the so called “middle income trap.” While some authors have argued for a policy switch after a low income country reaches the middle income stage, others have argued that the persistent adherence to

the same underlying “Comparative Advantage Following” strategy should allow a country to avoid the middle income trap.

Despite these differences both perspectives agree on the importance of equitable distribution as a condition for progress toward the high income status. Unfortunately, China has neglected the issue of inequality for too long, departing from the example of successful East Asian economies which generally have combined high growth with less inequality. This neglect of inequality has however now created a set of interconnected problems of unbalanced economy, over and wasteful investment, unsustainable growth, discrimination among its own citizens with regard to residence rights, social discontent, and environmental degradation. To resolve this set of interconnected problems, China has to address the issue of inequality by moving along both the “wage route” and the “redistributive route.”

In solving its current problems, China can also follow certain distinctive policies, such as promotion of cooperative ownership and protection of environment, which will allow it to emerge as a high income country with some distinction.

Finally, the categorization into low, middle, and high income levels is based on GDP, which is a deeply flawed measure of welfare (see Stiglitz, Sen, and Fitoussi (2010) for a recent discussion). It is particularly inadequate from the viewpoint of sustainable development, because it does not account for depletion and degradation of natural capital. It is therefore necessary to go beyond GDP and start thinking of welfare measure that can promote sustainable consumption and production (Islam 2012). From that perspective, it may be unnecessary to be preoccupied with raising per capita GDP. Instead, attention may be focused on whether individual countries and the world as a whole can ensure decent living for all the inhabitants, who can live in solidarity with each other and in harmony with the nature. The whole discussion regarding “middle income trap” can then appear in a very different light.

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¹ See for further details:

(<http://web.worldbank.org/WBSITE/EXTERNAL/EXTOED/EXTMIDINCCOUN/0,,contentMDK:21453301~menuPK:5006209~pagePK:64829573~piPK:64829550~theSitePK:4434098,00.html>)

² Apart from the scholarly articles, "middle income trap" has also received considerable attention in the popular press. See for example, The Economist (2011), Evans-Pritchard (2012), Paus (undated), Rhee (2012). See also the Asian Development Bank (2011).

³ Here, Kharas and Kohli appear to suggest that both labor *and* capital are low cost to countries at the low income stage. Such a statement is certainly controversial, even remembering that capital is globally mobile while labor is not. In fact one of the most important assumptions for Lin's CAF theory is that for low income country capital is scarce and hence expensive. Only when these countries become richer that capital becomes abundant and hence cheap. We will consider Lin's theory soon.

⁴ "The most significant difference between middle-income growth strategies and those of low-income countries is the need for the former to focus more on demand. In middle-income countries, traditional export cannot be as easily expanded as before because wages are higher and cost competitiveness declines. Export growth depends on introducing new processes and finding new markets, not just on expanding sales of the same product to existing markets. To do this, exporters must understand the quality, price, and consumer preference points of the global economy, which is a demanding task. Most firms start by developing this understanding in domestic markets, and then, if successful, they can develop into global brands (Kharas and Kohli 2011, p. 285)."

⁵ Kharas and Kohli (2011) also suggest that transition from low income to high income should lead to a switch from centralized to decentralized economic management and from physical accumulation of factors to productivity-led growth.

⁶ Postwar Japan, South Korea, Singapore, Taiwan, China were together branded as the East Asian Miracle, because the economies maintained fast yet sustained economic growth and improved income distribution simultaneously in the process. The income distribution is also more equal in provinces that follow more closely the CAF strategy (Lin 2012, pp. 250-251)."

⁷ Lin (2012) sees a connection between SOEs and problems in stock market: “The root cause of China’s speculative stock market is that the problems of SOEs cannot be solved as long as listed companies make no profit and shareholders receive no dividend (p. 194).”

⁸ Lin (2012) allows government role in providing infrastructure “so that transaction costs can be reduced, efficiency improved, and the prices of production factors gradually equalized (p. 171).”

⁹ “Despite the rapid growth over the past three decades, China’s per capita GDP was only \$3,650 in 2009, about 8 pct of that in the US. There is also a yawning gap between China and the rest of the developed world in per capita income, which China can narrow only with sustained growth, also critical to job creation for China’s growing urban and rural workforce.”

¹⁰ Lin (2012) takes note of the collapse of public services in rural areas: “Health, education, and social services are rather backward in rural areas. Before the reforms, college was free for all, and healthcare in rural areas was also publicly funded, with ‘barefoot doctors’ ... Although the services were underdeveloped, they could meet some farmers’ demand. But when the reform program kicked off, education and social services became commercialized, and prices were liberalized. So, many farmers found education and healthcare not only expensive but hardly accessible. If some family member had a severe illness, the family would become instantly impoverished (p. 165).”

Lin notes further, “Pre-reform China was egalitarian. With the deepening of reform and opening, some regions and some people got rich ahead of others, and the income gap between the urban and rural areas got wider. **Now the gap in China is the world’s largest.** Even in the cities, the income gap had been widening, with the unemployed and retired left behind. China’s Gini Coefficient has exceeded 0.42, higher than the internationally recognized warning line. In addition, health and education services have become inaccessible and unaffordable for the vulnerable (Lin 2012, pp. 247-248).”

¹¹ Calling China’s current “real estate” bubble as “apartment bubble” is of course an oversimplification, because apart from apartments, China’s recent construction boom involved infrastructure, office and commercial buildings, etc. However, apartment buildings certainly comprise the largest component of the construction boom.

¹² The Chinese government has recently imposed restrictions on the number of apartments that one can buy, hoping to contract the housing bubble, reduce demand for apartments, and bring down their prices. However, first of all, such administrative methods do not fit well with a market economy. Second, it is not too difficult for interested Chinese buyer to find ways to skirt these restrictions. Thus, instead of buying multiple apartments in the same city, one can do so in different cities. Similarly, instead of buying them under one’s own name, apartments may be bought under relatives’ names. It is therefore difficult to say how far these administrative restrictions will serve the purpose.