Private Sector Finance and Income Disparity in China: Why Economic and Social Tradeoffs Are False

Yasheng Huang

MIT Sloan School of Management

yshuang@mit.edu

Preliminary and incomplete. The citations are incomplete. Comments are welcome. This paper is based on an on-going book project on private sector development in China. The tentative title of the book is, Capitalism with Chinese Characteristics: Private Sector Development in China during the Reform Era.

Abstract

It is now widely acknowledged that China's social performance has deteriorated substantially in the 1990s. Many blame this outcome on economic reforms in the 1990s. Precisely the opposite is the truth. In fact, during the 1990s, in one critical area of reforms--financing of the domestic private sector firms—China made very little progress. Private sector financing became more difficult in the 1990s compared with the 1980s. This development prevented a market-based development in the private sector, which would have improved income distribution, as it had done in the 1980s.

Visitors to China and India often report nearly opposite impressions of the two nations. India assaults one's senses. People living in open squalors, the lack of sanitary facilities, and massive and sprawling slums in metropolises such as Mumbai and New Delhi easily give rise to the impression that India is a very poor and unequal society. China induces the opposite reaction. Its urban space is sanitary and is largely free of grotesque manifestations of poverty, such as massive slums. It is not surprising that visitors to China leave the country with the impression that it is one of the most successful countries in tackling income inequality and that India has done the opposite.

The reality is almost exactly the opposite. The most widely used measure of income inequality is the Gini index, which ranges from zero — perfect equality — to 100 — perfect inequality. In 2001, China's Gini index was 44.7; In India during the 1999-2000 period, the Gini index was 32.5. Also, according to World Development Report 2005, the lowest 20 percent of the Chinese population claimed 4.7% of income; in India, the corresponsing number is 8.9%. The wealthy people in China claim a far higher share of income than those in India. The top 20% of the Chinese population possess 50% of the income, compared with 41.6% for the top 20% of the Indian population. In fact, as David Dollar, the chief representative of the World Bank in China, has pointed out, India has scored a more impressive gain in fighting against infant mortality than China. The annual rate of decline in infant mortality since 1990 was 1.8% in China but 2.2% in India. As in so many other aspects of China-India comparisons, the visual impressions are often misleading.

There is another contrast between China and India that brings us closer to the topic of this paper: China's economic growth since the early 1990s has been accompanied by rising income inequality, whereas India's economic growth has been accompanied with declining income inequality. The Gini index for India in 1992 was 33.8; for China it was 37.6. During the course of the 1990s, in India the Gini index slightly improved from 33.8 in 1992 to 32.5 in the late 1990s. In China, the Gini index worsened, from 37.6 in 1992 to 44.7 in 2001. More recent data from the United Nations Development Program suggests that China's Gini index has continued to deteriorate and has reached 45.

Three often-repeated ideas are employed to explain the rise of income inequality in China. As widespread and as firmly held as these ideas, they in fact have no empirical or analytical basis. One idea is that income inequality must accompany economic growth. This is simply false. In India of the 1990s and Japan, South Korea, Taiwan, Hong Kong of the 1960s through 1980s and China itself during the 1980s, superb economic performance was not achieved at the expense of social equity. In fact, in the cases of Taiwan, Hong Kong, modern-day India and 1980s China, economic growth occurred with *improving* social performance.

A related idea is that economic growth itself contributes to income inequality. Some have attributed the increasing number of land disputes to economic growth. Growth, according to this logic, increases the value of the land and therefore gives rise to conflicts over the uses and compensation of an asset that has suddenly acquired value.

Although not stated explicitly, much of the official explanation for rising income inequality, as well as for rising protests in the countryside, rests on a version of this logic. The argument that land disputes arise because economic growth makes land more valuable is akin to saying that car accidents happen because there are cars on the street. This is true, but it is not saying much. More specifically, this logic fails to explain why, in other economies, rising land values have not always been accompanied by the kind of conflicts we are seeing today in China. Japan, Taiwan and South Korea, three regions with much higher people to land ratios and thus with a greater impact on land values arising from economic growth, never experienced land disputes on the modern Chinese scale. (On the other hand, the slow-growing Latin American countries in the 1970s and 1980s experienced land disputes on a substantial scale.)

The idea that economic growth contributes to social conflict rests on a similarly strange logic. For one thing, economic growth should create more resources, and with more resources a government should be better equipped to provide poverty-reduction and income-distribution functions. It is completely unconvincing to argue that social conflicts should rise with economic growth. By this logic, we should see social upheavals and political turbulence in regions such as South Korea, Taiwan, Japan, Hong Kong and Singapore in the 1960s and 1970s, and we should observe peace and stability in countries such as Angola, Uganda, and Nigeria. This idea simply does not make any sense.

The third widespread perception is that private sector development somehow has contributed to rising income disparity in China. Many members of the so-called "new left" — both in China and in the West — like to contrast the rising wealth accumulated in

China's private sector with the plight of laid-off workers in the state sector. While the images of these contrasts can be striking, the logic of the argument is extremely problematic. For one thing, these critics seem to have neglected a basic fact in their observation — the laid-off workers in the state sector are poor because they are laid-off. The next logical question is why the state sector laid off so many workers? At least one important part of this answer is that the state sector laid off so many workers because the state sector is massively inefficient. By this logic, an important reason why income disparity is rising in China is because the state sector is inefficient. It is rather strange for the critics of the market economy to have neglected this fundamental dynamic behind rising income disparity.

The fundamental reason for rising income inequality amidst rapid economic growth is that there are rigidities in a country that makes economic opportunities available to some people but not to others. Different countries have different types of rigidities in place that contribute to this outcome. For example, in a caste system such as the one in India, economic opportunities accrue to some castes but not to others, because mobility is sharply restricted across different castes. Lack of education is another form of rigidity. Economic opportunities accrue to those with knowledge, and thus those without knowledge cannot access the same economic opportunities. (Think of someone who knows little about computers at the height of Internet boom.)

Although not often stated this way, poor governance also constitutes a form of rigidity. The effect of poor governance is that it assigns far more power to some people than others. The privileged few can do well, not necessarily because they are specially talented or capable, but because they can exclude others from accessing the same opportunities. Corruption is one form of poor governance and one of the most important effects of corruption is that it restricts competition. Restricting competition then has the effect of preserving rent to the incumbents. While many people think of corruption as enabling the bribe providers to gain business opportunities, it is just as important to note that corruption prevents those who do not bribe from gaining access to the same business opportunities.

The proper approach to thinking about rising income inequality in China is to identify those rigidities that have prevented a fuller dissemination of economic opportunities in China. There are myriad rigidities in the Chinese political and economic systems. Among others, they include: 1) the household registration system (the *hukou* system), which, in its most basic and fundamental essence, is a caste system imposing massive constraints on the members of the lowest caste — China's rural residents; 2) a political system that assigns massive power to government officials; 3) various regulatory restrictions that favor the state-owned enterprises (SOEs) and a few politically-connected private businesses; and 4) a financial system that allocates capital on a political basis, rather than on economic grounds. Covering all of them in a single paper is an impossible task, and so this paper will focus on the role of China's financial system in contributing to China's rising income inequality.

To some, this focus on the financial system may be surprising. They might argue that this focus is directionally wrong. To the critics of market reforms, rising income disparity is a result of economic reforms. They see income disparity as a problem of the 1990s, and they often believe that economic reforms in the 1990s deepened substantially over the level prevailing in the 1980s. Thus, directionally, they view rising income disparity as correlating closely and positively with the degree of economic reform (of which financial reforms are an important component). In a similar spirit, others see the greater role of private businesses in the Chinese economy in the 1990s as a contributing factor to rising income disparity. The massive wealth accumulated in the private sector is often contrasted with the plight of laid-off workers in the state sector. By this logic, to the extent that China's financial system favors SOEs, indirectly at least, China's financial system ought to have alleviated income disparity.

This paper argues precisely the opposite. First, in a centrally planned economy such as China's, rapid development of the private sector should be fully compatible with a fair and equitable distribution of income. There is a simple reason for this: many of the first-generation private entrepreneurs themselves were from the under-privileged and the poorer segments of the society. Second, there is no empirical evidence supporting the widespread belief that the Chinese government implemented financial liberalization in the 1990s. In fact, there is substantial evidence that the opposite is the case. The leadership of the 1980s began bold and visionary financial reforms that vastly eased capital constraints on the then embryonic private sector, much of which was located in rural China. In the 1990s, the leadership reversed many of these economically productive and socially beneficial financial policies and restricted the credit available to China's private businesses as a whole and to the rural private businesses in particular. The restriction of credit availability to rural private entrepreneurs — together with lagging reforms of land ownership —probably is the single biggest contributing factor to the rising income disparity between the rural and urban sectors.

This paper begins with a section explaining why a market-based development of the private sector contributes to income equality. The next section details a central finding of this paper: that private sector access to financing was curtailed substantially in the 1990s, as compared with the 1980s. The final section offers some broad policy implications of our findings.

Why market-based private sector development benefits the poor

This paper adopts a narrower and a more conservative definition of the private sector. It includes the firms — or households in some of the data series — that are registered as explicitly private under the Chinese system. They are either individual businesses (*getihu*) or privately-operated enterprises (*siying qiye)*. The distinction between these two types of entities has become more blurred in recent years, but the most important nominal difference has to do with the size of employment. *Getihu*, by tradition, employ eight or fewer outside employees; *siying qiye* employ more than eight employees.

The advantage of this definition is that it is straightforward and unambiguous. The disadvantagei is that it is conservative and narrow. Our definition excludes those private firms with an ambiguous registration status. These firms are registered as collective firms, such as TVEs, rather than as private firms but are, for all practical purposes and from a management perspective, under private control. For example, as is well-known to China researchers, many Chinese entrepreneurs have registered their firms under the more politically-acceptable category of "collective firms" in order to alleviate policy constraints associated with purely private status. These so-called "red-hat" firms enjoy political protection, the ability to enter into businesses otherwise off-limits to *de jure* private firms, and easier access to credit and financing. Our registration-based definition also does not include those collective firms or SOEs that have been privatized but have retained their previous registration status as either collective firms or SOEs. According to various estimates, the number of "red-hat" firms and privatized firms in the 1990s was substantial.

One way that private sector development can improve income distribution is through the employment channel. In terms of the aggregate size, China's private sector is quite large today. As of 2003, the employment in the domestic private sector — defined as the sum of *siying qiye* and *getihu*, but excluding the collective and foreign sectors — was 47 million people. This is a substantial number, especially considering two facts. One is that the domestic private sector as a whole has drawn a fraction of financial resources in the 1990s (more on this topic later); the other is that the state sector has lost some 16 to 20 million jobs, while nonetheless having expended massive financial resources.

The total size of employment in the private sector understates the true social contributions of the private sector. The other important factor to consider is the composition of its employment. According to the 2004 private sector survey (referring to the 2003 data), about 25 percent of the workforce in the private sector was comprised of laid-off workers and about 50 percent of the workforce was comprised of rural residents. Thus 75 percent of the private sector workforce consisted of the least privileged members of the Chinese society. Opponents of this viewpoint might point to the low wages and lack of job security in the private sector. This is all true; in fact, according to the 2004 private sector survey, the wages in the private sector are lower than the wages in the state and collective sectors. But this criticism ignores a realistic counterfactual. That is, the laid-off workers receive zero wage and that rural residents have low earnings (which is in part induced by policies, but this is a separate issue). Relative to these counterfactuals, jobs in the private sector remain an improvement.

However, the above dynamic may have preventeda bad situation from getting worse, i.e., the private sector, by offering income-earning opportunities to people otherwise without these opportunities, may have prevented income disparity from rising even faster than it would have. This dynamic itself does improve income distribution. In fact, private sector development can improve income distribution under the right circumstances — the main condition being a liberal financial policy. As I will demonstrate later in this paper, in the 1980s China began to create a policy environment in which private sector development improved income distribution, but in the 1990s much of this policy environment disappeared.

The main reason why private sector development can improve income distribution is that many of the private entrepreneurs themselves came from humble socio-economic backgrounds when China began its reforms in the 1980s. Here, my findings rely on a number of private sector surveys implemented in 1991, 1993, 1995, and 2002. Unfortunately, the private sector surveys conducted in the 1980s are not readily available, and therefore, one has to make inferences about the situation in the 1980s based on the retrospective questions contained in these surveys. The 1991 survey — Individual Business Survey (IBS) or 中国个体工商户调查1991 — is the closest to the decade of the 1980s, and I will use this survey to illustrate the characteristics of private sector development in the 1980s.

One of the most interesting features of private sector development in the 1980s is that peasants accounted for the largest share of entrepreneurs who launched private businesses. According to the 1991 IBS, of 13,259 entrepreneurs, 55 percent of them had a rural *hukou*. Between 1979 and 1990s, the years with the lowest percentage shares of rural entrepreneurs are 1979 (48.6 percent), 1988 (53.9 percent), 1989 (53.7 percent), and 1990 (48.8 percent). For all the other years, the percentage ratios are above 56 percent. The 1993 private sector survey confirmed this general portrayal.

Many observers believe that private sector development is an urban affair. Precisely the opposite is the case. Private sector developed fastest in those provinces that were largely rural in the late 1970s. Today, some of the largest private firms in China had substantial rural origins, reaching back to the 1980s. The Hope Group, China's largest animal feed and agricultural processing firm, was founded in a rural area near Chengdu. Some of China's largest home appliance firms, such as Kelon and Galanz, were founded by rural entrepreneurs. Zhejiang, which has produced half of China's largest 500 private firms (as of 2002), was a heavily agricultural province in the late 1970s. The city that is billed as the "capital of capitalism" in China — Wenzhou of Zhejiang province — was largely a rural area. Many people forget that Guangdong province in the late 1970s was also a largely rural province.

The 1991 IBS reveals some surprising but extremely indicative insights. If we define private sector development in terms of the size of individual firms, rather than in terms of the aggregate size of private firms as a whole, then in the 1980s, and especially for the first five years of the 1980s, the most successful private sector firms are found in Guangdong. However, they are also found in interior regions, such as Hubei, Guizhou and the city of Xian of Shaanxi province. Consider the size of the largest private firms in the 1980s, broken down by the regions covered by the 1991 IBS. The largest private firms here are defined as those having a registered capital larger than 75 percent of the sampled firms. By this criterion, the largest firms are found in the city of Dalian. The average size of those firms in Dalian is 24,667 yuan, as measured by registered capital; the second largest cluster of firms is found in Guangdong with a registered capital of 24,106 yuan. An interesting finding is that private firms based in such interior and backward provinces as Hubei and Guizhou — the poorest province in China — are surprisingly large. The average registered capital of the largest firms based in Hubei is 13,681 yuan and that of the largest firms based in Guizhou is 16,741 yuan. To be sure these are small in comparison with the largest firms based in Guangdong but they are substantially larger than private firms based in Shanghai. The average registered capital of the largest private firms based in Shanghai is only 11,701 yuan.

In fact, if one is to just look at the early years of the 1980s, from 1979 to 1983, the substantial development of the private sector in interior and rural regions is even more pronounced. During this period, there are 310 firms that are in the top 75 percentile in terms of the size of registered capital i.e., about 2,000 yuan. Of these 310 firms, 100 were based in Guangdong, and so Guangdong dominates the sample of the largest firms. Outside Guangdong, firms based in Hubei accounted for 68 out of 310, and firms based in Guizhou accounted for 46 out of 310. In contrast to Guizhou, Shanghai — China's richest region — only produced 17 large firms by our definition.

Another illustration of the same dynamic is that an interior city, Xian produced many large firms. It boasted 11 large firms, as compared with 2 between Dalian and Shenyang and 11 from Shenzhen. That Xian had the same number of large private firms as Shenzhen during the 1979-1983 is an extraordinarily telling fact. Shenzhen was designated as a special economic zone and enjoyed far greater regulatory autonomy as compared with Xian. Yet Xian was able to create a cluster of large private firms, despite the presumed policy and regulatory restrictions in place, an extremely interesting and surprising finding. (During the 1990s, Xian began to lose its position relative to other provinces. Why this city lost its initial advantage is a fascinating research question.)

The financing environment for domestic private sector firms

The empirical illustration above suggests a number of interesting hypotheses. One is that it is incorrect to believe that the private sector development is an urban phenomenon. Rural and poor provinces such as Guizhou and Hubei in the early 1980s claimed many of largest private sector firms in the country. While Guangdong is an industrial powerhouse today, in the late 1970s, it was one of fairly poor and rural provinces in the country, and yet it had the largest concentration of private firms. Private sector development lagged substantially in Shanghai, the richest and the most industrial region in China.

A second hypothesis is that agricultural reforms may have contributed substantially to private sector development. The mechanism might work like this: Agricultural reforms increased agricultural surpluses, raised labor flexibility in the countryside, solved incentive problems in agricultural production, privatized rural ownership of capital goods, and liberalized rural factor markets, which in turn contributed substantially to private sector development. For example, one can hypothesize that the commune system pinned down the otherwise entrepreneurially-oriented peasants to land and to agricultural activities, and labor market inflexibility and restrictions of factor markets prevented a “scaling-up” of more value-added production — for example, in agricultural processing. The dismantling of the commune system unleashed the entrepreneurial supply.

A third hypothesis is that the vibrant private sector development, especially in the rural areas, might have contributed to the narrowing of income gap between urban and rural areas. As many China scholars know, the urban/rural income disparity decreased in the 1980s, especially in the first half of the 1980s. The standard view is that agricultural reforms, which successfully boosted rural income, contributed to this development. But another — and complementary — hypothesis is that the private sector development in the rural areas, which most likely produced even larger income streams to the rural residents than agricultural production, also contributed to this income leveling effect.

A fourth hypothesis is that the vibrant private sector development in the rural areas in the 1980s did not happen by accident. Successful private sector development required a supportive policy environment — enhanced property rights protection and ease of financing. Another possibility is that the income disparity between rural and urban areas and between coastal and interior regions began to rise substantially because the policy environment for the domestic private sector became adverse in the 1990s. There are plausible reasons for one to expect that an adverse change in the policy environment for the domestic private sector could have a differential effect on cities or coastal regions, as opposed to rural or interior reasons. The reason is that in the 1990s cities and coastal regions received a huge inflow of foreign direct investment (FDI), which boosted economic growth even in the absence of a vibrant and healthy domestic private sector. The economic growth in the interior regions, however, depended more critically on a supportive policy environment for the domestic private sector because these regions do not attract FDI. Thus, in the 1990s the income disparity between rural/interior regions and urban/coastal regions grew substantially because the domestic private sector failed to develop in the rural/interior regions despite the fact that rural/interior regions enjoyed some substantial initial advantages in the 1980s. It is in this sense that an inefficient financial system might have contributed to the worsening income distribution in the 1990s.

Is there any evidence that private sector development was less vibrant in the 1990s than in the 1980s? Is there any evidence that financing constraints increased in the 1990s over the level prevailing in the 1980s? The conventional wisdom among China scholars and the perception among the general public would tell you that the answer to both questions is “No.” A careful examination of systematic evidence would lead to a “Yes” in answering both of these questions. This paper will deal with these two issues separately below.

Private sector development in the 1980s and 1990s

The constraining effect of a poor institutional environment manifests itself in the size of private firms, not necessarily in the size of private sector as a whole. The reason is simple and intuitive. A poor institutional environment is defined as one that protects property rights poorly and one that financially discriminates against efficient but politically weak firms (such as private firms in China in the 1980s and 1990s). Under such an environment, entry can be still massive. It is difficult for predatory governments to squeeze small and numerous firms that can rely on inheritance, savings, and informal finance to enter into small-scale businesses. The total size of the private sector can grow as long as the entry of small firms is relatively unimpeded. Under these circumstances, the combination of dynamism among small private firms and the poor efficiency of SOEs can lead to a quick rise of the private/state sector ratio.

The rise of this ratio is used by many to illustrate the improvement of the institutional environment for private firms but it is important to keep in mind that this ratio can rise without any institutional improvement as long as the entry of small firms continues (and as long as SOEs, which appear in the denominator, continue to be inefficient). A far better indicator of the changes in institutional environment is the size of individual firms, not the size of the entire private sector.

Here the evidence is sobering. Let me cite one large-scale survey conducted in 2002 by the All-China Federation of Industry and Commerce, which covered 3,258 private firms in all the provinces in China. All the surveyed firms were selected from the registration lists maintained by the local bureaus of All-China Federation of Industry and Commerce. Thus, these firms were explicitly registered as private firms at the time of the survey, which included some enterprises converted from SOEs or collective firms. Because the federation tends to have large firms as its members, this survey implicitly covered relatively large private firms in China. The main questions that the survey covers include: (1) firm size, status of development, organization, and operation; (2) management system and decision-making style; (3) social-economic background of enterprise owners; (4) social mobility and network of owners; (5) source and composition of employees and employee-employer relations; (6) self-assessment by entrepreneurs on a range of issues related to government-business relations, business environment, financing, and (7) income, expenditures and assets of entrepreneurs.

Based on the results from this survey, I have found evidence that the individual size of private firms at the time of registration remained fairly flat during much of the 1990s and that the average size of private firms in the 1980s was surprisingly large. This is especially true using the most common measure of firm size in the economic literature — employment per firm.

Chart 1
Employment size of private firms in their initial year of operation, 1980-2001

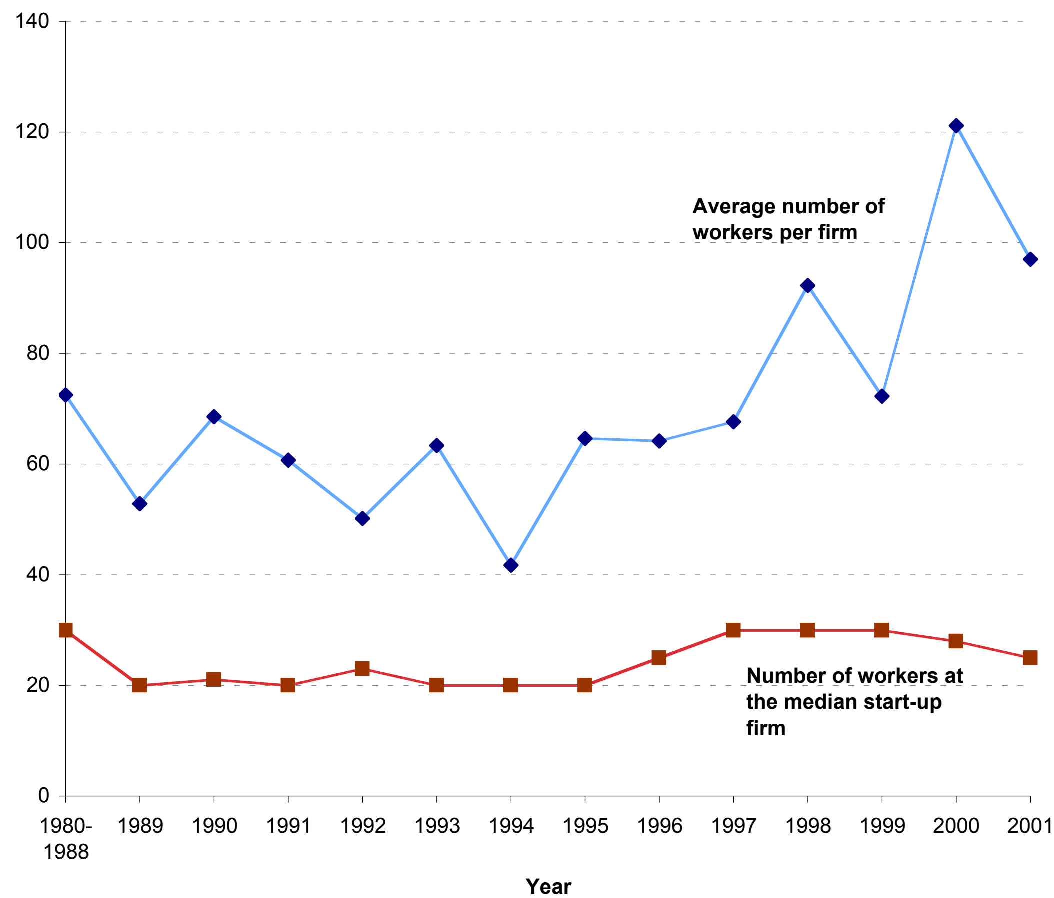


Chart 1 is based on the private sector survey conducted in 2002. One issue in the survey is how many employees were hired in the first year of the business. We use this question to show the evolution of firm size over time. A tentative reading of Chart 1 is that the firm size changed over time in a highly uneven fashion. Of those firms polled in

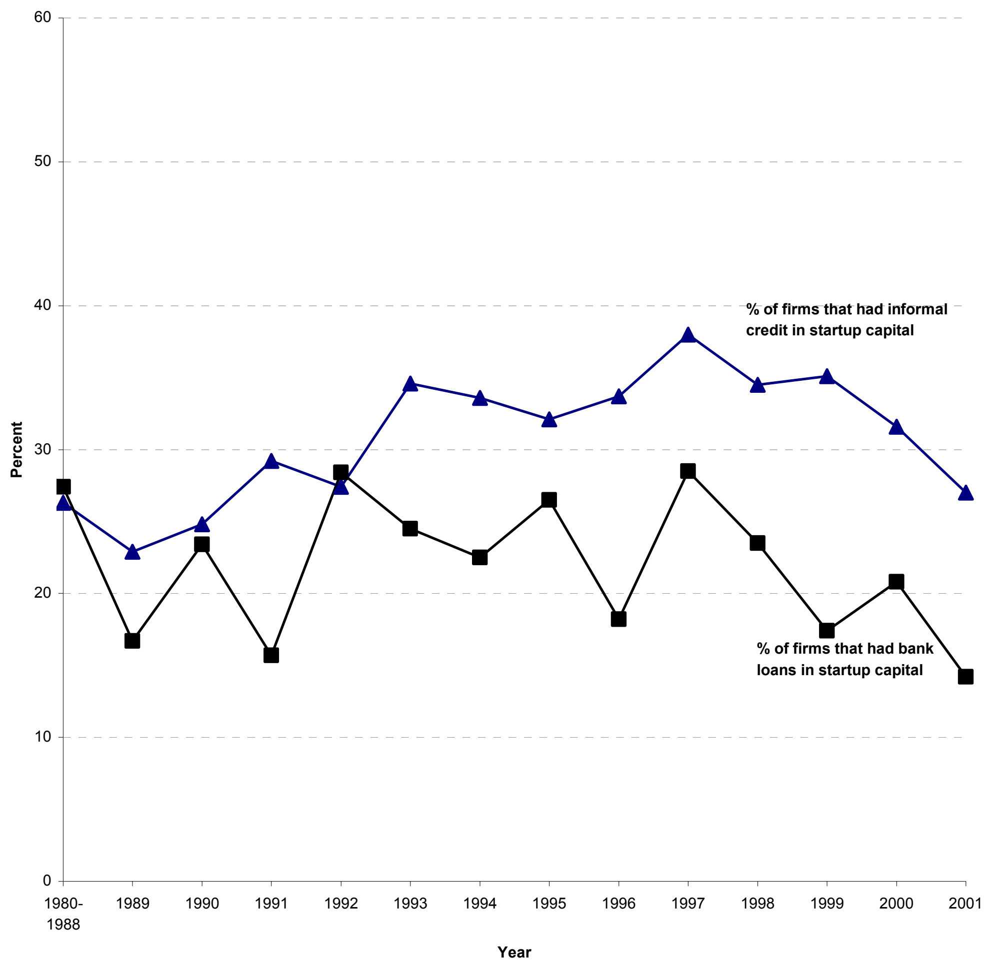
2002, the average number of employees during the initial year of operation for firms established during the period 1980-1988 had already reached 72.5 persons. From that level, the size of start-up firms declined, although not linearly, until 1998, when the average employment for new firms was 92 persons. Thus between 1988 and 1998, the average size of newly established private firms was actually smaller than the prevailing number earlier in the 1980s.

More tellingly, the median size of new private firms did not change at all. It was 30 during the 1980-1988 period, declined during the 1990s, and only again recovered to 30 in 1997. The size of newly established private firms has become considerably larger since 1998, in part because of privatization. Since 1998, some of the small and medium SOEs have been privatized. These SOEs, although small by the SOE standard, are still quite large by the standards of private firms. The 2002 survey shows that privatized firms are much larger than privately-founded firms. One major improvement in the 1990s, compared with the 1980s, is the privatization policy, but it should be pointed out that this policy was adopted very late in the decade and there were in fact some privatization activities in the 1980s as indicated by the 2002 survey.[1] Financing environment for private firms

The data are drawn from the same 2002 survey. Prior to the 2002 survey, four other nationwide private sector surveys showed that private entrepreneurs consistently ranked financing as their top constraint. Each of these surveys shows that financial liberalization in the 1990s was tentative at best; each reflects the presence of policy reversals. Chart 2 presents trends showing the financial treatment of private firms in the 1990s relative to the average financial treatment of private firms in the 1980s.

[1] If nothing else, in this research project I hope to gain a deeper understanding of the 1980s rather than simply assuming that the business environment improved linearly and across-the-board in the 1990s.

Chart 2
Formal and Informal Financing in the Startup Capital, 1980-2001



This chart shows no substantial increase during the 1990s in the percentage of private firms receiving bank loans in their initial year of operation. Chart 2 shows that at the end of the 1980s informal and formal financing already played similar roles, as measured by the percentage of private firms receiving loans from formal and informal channels. During the course of the 1990s informal financing substantially overtook the formal financing. Unless one assumes, unrealistically, that there is a natural preference for informal over formal financing, this development suggests that private entrepreneurs turned to informal financing because they could not get formal financing.

These data are entirely consistent with the data on the lending side. As a share of total lending, in fact, private sector lending in the 1990s was smaller than in the 1980s.

This is in large part because of the crowding-out effect of TVEs. In the mid-1980s, TVEs and private firms received about the same shares of bank lending. (Bank documents in the 1980s repeatedly called for equal treatment of TVEs and private firms.) Beginning in the early 1990s, TVEs, while far less efficient, substantially overtook private firms in bank lending, only to fail on a massive scale toward the end of 1990s and to accumulate huge non-performing loans on their books in the process.

Conclusion

While many contemporary observers of China believe that the 1990s represented a golden era of China's economic development, my own view is that the future historians will reach a very different verdict on the 1990s. The seemingly faster GDP growth rate— by about 1 to 1.5 percentage points — in the 1990s over that in the 1980s ought to be appropriated and discounted by a substantially higher investment/GDP ratio, an extremely high non-performance loan ratio, a worsening social performance and rising tensions in the society. While the ideological bias against the private sector eased considerably in the 1990s, the financing environment in fact deteriorated during much of the 1990s.

There are ominous indications that China today is substantially less stable than it was in the 1980s. China's Ministry of Labor and Social Security has issued a warning that China's growing income gap is likely to trigger social instability after 2010 unless the government is able to resolve the disparity. The Ministry's income research Institute's President, Su Hainan said that the country's income disparity reached the crucial yellow stage, the second most serious in a scale of four, as defined by the institute, and it will reach the red stage in five years if nothing is done to address the problem.

Protests in China have increased at a stunning rate. Between 1993 and 1997, the total number of demonstrations rose by some 268%, from 8,700 to 32,000. According to official figures released by the Ministry of Public Security, in 2003, there were a total of 58,000 incidents of unrests. In 2004, this number rose by 74,000 incidents, involving some 3.6 million residents. Apart from the sharp increase in the number of unrests, there are a number of new developments that bode ill for the prospects of social stability in the next 5 years.

One is that in the 1990s and the early 2000s the incidents of unrest were relatively concentrated geographically. For example, Liaoning province experienced 9,559 incidents of unrests between 2000 and 2002. This was a large fraction of the publicized number of incidents — around 50,000 during this period. In many ways, the unrest in that province can be easily explained. Liaoning province was the bastion of socialism, and the SOE reforms and poor performance have led to joblessness and income stagnation in that province. However, in the last two years, the geographic scope of unrests has widened substantially. Incidents of unrest were recorded not just in struggling provinces but also in prosperous provinces. Zhejiang, Guangdong, and Fujian have all witnessed large-scale protests. Even Shanghai is not immune.

The rising number and the level of protests are a sign that those rigidities, whichhave reduced economic mobility, have increased in scope and severity in the 1990s. The long-run consequences of this development are substantial. For one thing, it undermines the political support for further economic reforms. Many losers, as a result of these rigidities, understandably blame the problem on economic reforms even though the underlying reason is precisely that the reforms have not gone far enough. The other consequence is that these structural rigidities have led to a substitution of drivers of economic growth. In the 1980s, because economic growth benefited the vast majority of the population, domestic consumption rose along with economic growth. In the 1990s, the growth was more re-distributive — the growth benefited one segment of the population at the expense of another segment of the population. The end result was a contraction of consumption. The consumption to GDP ratio in the 1990s declined by some 10 percentage points compared with the 1980s.

The good news is that in the last two years, Chinese leaders have begun to address the country's institutional gaps, including a Constitutional amendment in 2004 that strengthened private property rights protection. But they could do far more and they should implement some of the financial reforms sooner rather than later, including immediately granting peasants ownership of the land they till, re-privatizing what were substantially private financial institutions in the 1980s — rural credit cooperatives — and opening China's financial sector to entry by both domestic and foreign private institutions.