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# How Harmonious is China?

## —The Outlook for Growth, Inequality and Social Instability—

By Yuji Miura

Senior Researcher

Center for Pacific Business Studies

Economics Department

Japan Research Institute

### Summary

1. For many years China's goal has been to build a society that is basically prosperous. The Hu Jintao administration has added two new goals, the "harmonious society" and the "scientific development concept." Behind this change is an acute sense of concern that China has reached the limits of its existing growth model, which is referred to as the "extensive growth" pattern. The influence of this unease on government policy has brought measurable progress in some areas, including the increased priority given to rural communities, the quality of life and inland regions. However, it appears that China still has some distance to go on its path to a "harmonious society," as evidenced by a continuing rise in the Gini coefficient, an indicator of inequality in income distribution.

2. Kuznets discovered that inequality follows an inverted U-shaped trend in developing economies. Based on this theory, the current expansion of income inequality in China can be attributed to wide differences in productivity between industries, and to an increase in the number of self-employed people. Also, the government is causing inequality to expand rather than reduce through distortions in social security systems, including pensions and health care. There is a strong possibility that inequality will not start to reduce in the future. Furthermore, barriers to social mobility are growing higher, increasing the level of social instability in China.

3. Few observers would predict uncontrollable unrest in China in the near future. First, monitoring and restrictions in information flows prevent groups that cause disturbances from coordinating geographically or aligning their positions. Second, China is more tolerant of inequality and has a stronger commitment to competition than the United States. Third, the flash point may not be as close as some would imagine, since peasant workers (*nong-min-gong*) do not compare themselves with people who have urban family registers, and the problems are not serious enough to indicate that inter-class conflict is imminent.

4. However, the Communist Party cannot afford to be complacent for a number of reasons. First, information technology continues to improve, and immigration is becoming commonplace. In this environment, it is becoming increasingly difficult to prevent groups from collaborating by means of reactive strategies, such as information restrictions and monitoring. Furthermore, protest activities are becoming both larger and more extreme. Second, overly optimistic estimates of the social mobility effects of education are being corrected, and at the same time there is growing awareness of the problem of inequality of opportunity in secondary and higher education. Tolerance of inequality and the drive to compete are both expected to weaken rapidly. Third, with peasant workers increasingly seeing themselves as urban residents, it is possible that assessments of inter-class conflict will change.

5. How will the Communist Party and the government cope with a society that is becoming increasingly unstable? This article puts forward three scenarios: (1) maintenance of the status quo, (2) increased redistribution, and (3) a shift to democracy in response to the emergence of the middle class. However, in addition to the factors mentioned in 4. above, the first scenario will also be affected by a lack of progress toward a growth model in which the economy is driven by consumer spending, and by the high growth rate that would need to be maintained. A key factor affecting the second scenario is the lack of consensus within the party and the government concerning whether or not the achievement of social harmony is a goal that should be pursued, even if risks are involved. As far as the third scenario is concerned, there is little evidence of any growth in the depth of a middle class with both education and income, and it is possible that those who make up the middle class are divided according to the ownership formats of the organizations to which they belong. For these reasons, none of the scenarios are very likely to become reality, and the outlook is becoming increasingly uncertain.

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## Introduction

In contrast with the serious problems still affecting the advanced economies in the wake of the financial crisis, China is on track to achieve economic growth of around 8% in fiscal 2009. There is a clear difference in momentum between the Japanese economy, which will inevitably shrink as Japan's population declines, and China's economy. The discovery of ways to harness China's growth potential to its own economic growth has become a key priority for Japan. At the same time, Japan is afraid of becoming too deeply linked with China, a fear that has been manifested in calls for a "China+1" strategy.

Investment in China involves a wide variety of risks. The unpredictable risk factor that causes the greatest anxiety for investors is the problem of growing social instability. Income inequality continues to expand, as does the incidence of disturbances triggered by land requisitioning, environmental contamination and other problems. It seems unlikely that there will be easy solutions to these issues. Another source of concern is uncertainty about the links between these problems and ethnic minority issues and democratization.

The purpose of this article is to assess China's stability. Social stability is affected by political, economic and social issues. To understand the overall situation, we need to go beyond these separate fields and instead take a multidisciplinary approach. However, little progress has been made with studies on this basis, and researchers working from this perspective are likely to encounter conflicting social trends in different areas. For example, despite evidence of expanding income inequality, researchers may also discover that peasants and migrant workers are very satisfied with their living standards.

Economics is an excellent tool for measuring the extent of income inequality and explaining the processes that cause inequality to increase or decrease. In recent years, the integration of economics with other disciplines, such as psychology and neurology, has resulted in tangible progress toward an understanding of the conditions under which income inequality becomes a problem. For

this reason, the problem of increasing social instability in China will be examined in this article primarily from the perspective of income inequality. However, sociological research has also yielded some extremely interesting data concerning social stability. These insights will also be used actively in this article as we attempt to provide a coordinated interpretation of the social situation now and in future.

In Part I we will examine the efforts of the Hu Jintao administration to foster social stability, and the result of those efforts. In Part II we will use the hypothesis of a inverted U-shaped trend, as proposed by Kuznets, to ascertain whether income inequality will continue to expand in China. In Part III we will analyze the factors that induce social instability and put forward the view that the level of instability in China is rising. We will conclude in Part IV with an analysis of the probability of a number of scenarios about China's projected future path.

## I. The Challenges for the Hu Jintao Administration

The Hu Jintao Administration has begun to make fundamental changes to the economic growth model known as "extensive growth." This section begins with an analysis of the administration's sense of crisis concerning the current economic and social situation. We will then examine how this sense of crisis has been reflected in policies and look at the results of those policies. Finally, we will show that the process of creating a "harmonious society" is still only partially completed.

### 1. A Sense of Alarm in the Hu Jintao Administration—from Basic Prosperity to the Harmonious Society

For many years, the goal of the Communist Party and the government has been to create a basically prosperous society through the reform and open-door policy. The phrase *xiaokang* (literally, "small prosperity") or "basically prosperous," signifies a standard of living that meets material

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needs and provides a certain amount of surplus. *Xiaokang* appears to represent the next stage of development after *jihan* (literally “hungry and cold”) or desperate poverty, which is a level at which material needs are not met, and *wenbao* (“warm and satisfied”), which is the minimum standard of living at which material needs are largely met. The goals set by Deng Xiaoping were to double China’s GDP relative to the 1980 level in 10 years, and to achieve the minimum standard of living by 1990 and basic prosperity by 2000<sup>(1)</sup>.

According to a government assessment prepared in 2000, around 70% of China’s population has achieved basic prosperity<sup>(2)</sup>. Although Deng’s target was not reached, 20% of remaining population were close to that level. On this basis, then General Secretary Jiang Zemin stated at the 16th CCP Congress in 2002 that China had reached the initial stage of basic prosperity and set the goals of doubling GDP in 10 years and building a “generally prosperous” society by 2020.

These goals were inherited by General Secretary Hu Jintao. However, Mr. Hu was also concerned about distortions caused by rapid economic development. This concern led him to add two new goals: the “harmonious society” and “scientific development.” Neither concept has been clearly defined, but their basic meanings can be surmised from an analysis based on the 11th five-year plan (2006-2010) (2006) and the report to the 17th CCP Congress (2007).

The target of the “harmonious society” concept is income inequality between coastal and inland regions and between the urban and rural sectors. The extent to which this goal is achieved appears to have a major influence on social stability. “Scientific development” is a comprehensive philosophy concerning the economic development path that China should follow and the processes involved in development. In addition to the goals of achieving basic prosperity and social harmony, the government has also made its policies people-focused, in the sense that economic development is viewed as a process that must ultimately advance the interests of the people. Another feature of the policy is its emphasis on balance between economic development and resources and the environment.

All of these issues have been highlighted before. However, the elevation of the phrase “harmonious society” into words representing the future vision for society, and the introduction of the “scientific development” concept and its positioning as an urgent priority for the Communist Party and the government can be seen as symbolic of the approach taken by the Hu Jintao administration.

The emergence of these new concepts is an indication of strong concern that the traditional economic model known as “extensive growth” has reached a dead-end. Under this traditional model, China focused on the maintenance of high economic growth and the expansion of per capita income. These goals allowed the Communist Party and government to strengthen their own legitimacy and enhance social stability. Furthermore, improved social stability attracted foreign investment, leading to accelerated growth. This correlation between growth and stability was seen as a robust link that would not easily break down.

However, the acceleration of economic growth has brought widening income inequality, while soaring education and healthcare costs have eroded the quality of life. Other problems to emerge include environmental pollution and energy shortages. The mechanism that allowed China to achieve progress in all areas simply by maintaining high economic growth has gradually broken down. There is a sense of crisis even within the government, and some officials have expressed concern that the Gini coefficient, an indicator of inequality in income distribution, has climbed above the danger level, while others are calling for urgent action without a moment’s delay on a range of problems, including resource shortages and environmental damage.

What the Hu Jintao administration is seeking through economic development is not the physical expansion of material capital, but rather economic growth with quality and sustainability. The keys to this goal is the improvement of human capital, as measured in terms of health and education, natural capital, in the form of environmental and resource sustainability, and social capital, specifically social stability and mutual trust.

These are all obvious goals, given China’s sta-

tus as a middle-income country and the likelihood that China will overtake Japan and become the world's second biggest economic power. However, few countries have overcome these challenges and joined the ranks of the advanced nations. While China's huge population is often seen as a positive factor for economic development, in part because of its potential to attract foreign investment, it sometimes has a negative effect on efforts to improve the aforementioned three types of capital. There can be little doubt the achievement of this goal will involve enormous challenges.

## 2. Has the Administration's Sense of Crisis been Reflected in Policy?

What effect has this sense of crisis within the Jintao administration had on government policies? In this section, we will briefly review government policies from the narrow perspective of issues relating to the creation of a "harmonious society," in line with the approach taken in this article. We will then assess the outcomes of each policy.

First, the government has strengthened policies that give explicit priority to the rural sector. The Chinese government and the Communist Party customarily announce policies that will have the highest priority in each year in the "No. 1 Policy Document." The "Three Rural Issues," which relate to agriculture, rural communities and peasant poverty, have been included in the No. 1 Policy Document in five successive years since 2004. In 2006, the government announced that it would abolish agricultural taxes. It also increased agricultural support expenditure, which rose sharply from 4.6% of fiscal expenditure in 2003 to 6.8% in 2007.

Second, the government has reviewed systems and policies that impact on the quality of life. In the education sector, compulsory education for peasants became free. The government also strengthened initiatives to ease the livelihood problems of peasants and migrant workers from rural areas (*nong-min-gong*). An amended labor law strengthening worker's rights took effect in 2008, and in 2010 the government will further enhance social security systems under a new social

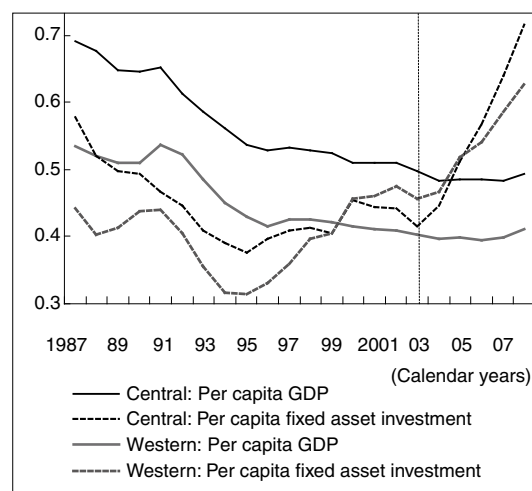
insurance law.

Third, there are initiatives to raise the level of development in inland regions. The symbol of these policies is the Great Western Development Strategy, which was formally adopted by the National People's Congress in March 2000. The strategy consists of large-scale infrastructure projects. The four key projects are the West-East Electricity Transfer Project, the South-North Water Diversion Project, the West-East Gas Transmission Project, and the Qing-Zang Railway Project<sup>(3)</sup>. The cumulative total of investment during the first five years of the program is believed to have been in excess of 1 trillion yuan, and the projects are still in progress.

The benefits of social security reforms have not yet become apparent. However, there has already been conspicuous progress toward the reduction of inequality between coastal and inland regions. Fig. 1 compares per capita GDP and per capita fixed asset investment in eastern, central and western China. A rapid increase in fixed asset investment in mid-western China since 2003 has halted the expansion of inequality in per capita GDP. The gap between eastern China and central and western China was reduced, albeit marginally, in 2008 and 2007 respectively.

Assessments of life satisfaction have basically followed an upward trend, albeit with fluctua-

**Fig. 1 Per Capita GDP and Fixed Asset Investment (East = 1)**



Notes: The values are weighted averages.  
Source: Compiled using data from CEIC.

tions in individual years. Of particular interest is the fact that satisfaction levels in low-income rural areas have exceeded those in the urban sector in every year except 2006 (Fig. 2). In general, assessments of objective characteristics, such as satisfaction and happiness, tend to rise in proportion to income levels (Tsutsui [2009]). The fact that satisfaction levels in the rural sector have run counter to this tendency can be interpreted as an indication of the effectiveness of initiatives implemented by the Hu Jintao administration.

In 2006, the government substantially revised its prosperity standard to create an indicator that would provide a more concrete reflection of actual conditions. The new prosperity index assesses prosperity from six perspectives: ① economic development, ② harmony, ③ quality of life, ④ democratic and legal systems, ⑤ national character, and ⑥ resources and the environment. A feature of the revised standard is a shift away from the previous emphasis on material prosperity toward an increased emphasis on the quality of life<sup>(4)</sup>.

Assessments going back to 2000 show a steady rise in the new prosperity index (Fig. 3), indicating that there has been significant progress not only toward the achievement of general prosperity, but also toward the realization of harmony and scientific development. These findings are certain

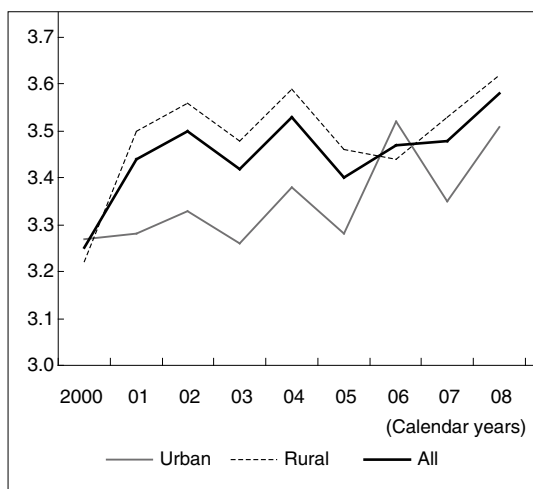
to be used at the next CCP Congress and in the next five-year plan to show that China has moved away from the extensive growth pattern, and also to maintain the legitimacy of the Communist Party and the government.

### 3. “Harmony” Still a Work in Progress

These initiatives can be seen as an indication of the Hu Jintao administration’s awareness that China has reached a turning point in its history. As shown in this section, however, a totally different assessment is possible when the measures are viewed from a different perspective. According to that assessment, China’s efforts to create a “harmonious society” may not be progressing according to plan.

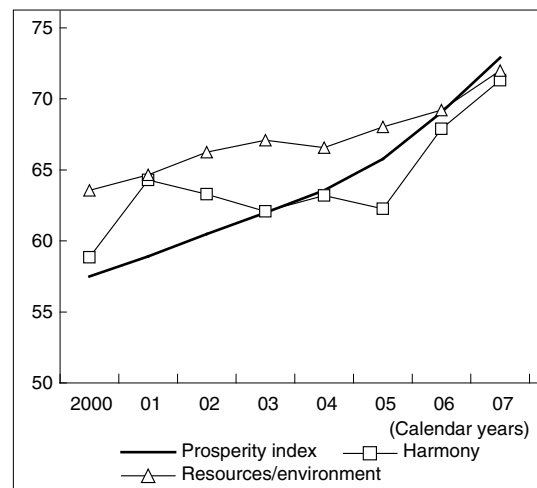
First, income inequality is not shrinking at the national level. There have been few attempts to produce consistent time-series data, since the National Bureau of Statistics does not publish Gini coefficient data on a regular basis. Fig. 4 is based on several of these series. All show that while the Gini coefficient for all of China dipped in the first half of the 1990s, it has generally followed an up-

**Fig. 2 Life Satisfaction**



Notes: The data are based on quintile assessments. A higher figure indicates a higher level of satisfaction.  
Source: Chinese Academy of Social Sciences, 2009 [Blue Paper on Society 2009]

**Fig. 3 New Prosperity Index**



Notes: The maximum score is 100.  
Source: Compiled using National Bureau of Statistics of China, 2007-nian Zhongguo Quanmian Jianshe Xiaokang Shehui Jincheng Tongji Jiance Baogao [2007 Statistical Report on Progress toward the Creation National Construction and Progress toward the Establishment of a Prosperous Society Throughout China] ([http://www.stats.gov.cn/tjfx/jdfx/t20081218\\_402527091.htm](http://www.stats.gov.cn/tjfx/jdfx/t20081218_402527091.htm))

ward trend since the second half of the 1980s. A similar pattern emerges from an analysis of references in the Chinese media, many of which suggest that the coefficient rose from 0.47 to 0.48 between 2005 and 2007. None of this evidence points to a reduction in income inequality.

The fact that the Gini coefficient has continued to rise despite a reduction in per capita GDP gap between coastal and inland regions reflects an increased contribution from urban-rural inequality or inequality within the urban sector (Fig. 5). Differences based on the industries in which people work or their family register status now play a bigger role in inequality than geographical differences between coastal and inland regions.

Second, satisfaction levels cannot be accepted on face value. A study of the factors that influence satisfaction (Duan and Chen [2009]) indicates that the main factors affecting satisfaction levels in both urban and rural sectors are health, marital status and age. Research in Japan<sup>(5)</sup> has shown that personal attributes also influence satisfaction levels, and it would be premature to assume that a rise in lifestyle satisfaction among rural people is indicative of progress toward the “harmonious society.”

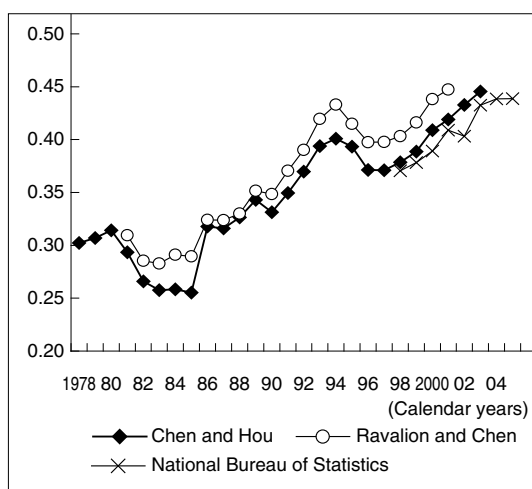
Third, we cannot be certain that changes to systems and policies that affect the quality of life will

move China in the direction of greater harmony. Obviously the introduction of free compulsory education has reduced the cost burden on low-income households. However, compulsory education also became free in urban areas in 2008, so this can no longer be seen as a policy that favors the rural sector. Furthermore, the fact that participation in compulsory education was close to 100% even before it became free casts doubt on the contribution of this policy to the achievement of “harmony.”

For example, a survey of elementary and junior high schools in Gansu Province revealed that the pass rate for literacy and numeracy tests in rural areas was 66.9%, compared with 85.0% in urban areas<sup>(6)</sup>. There are aspects of educational inequality between urban and rural areas that are not reflected in school attendance ratios, including the lower quality of teaching personnel in rural areas because of a lack of applicants for teaching positions. If the government wants to promote “harmony” through education, it should focus on measures that would contribute to real equality of opportunity, such as the achievement of greater homogeneity in compulsory education and the expansion of scholarship systems to support participation in higher education.

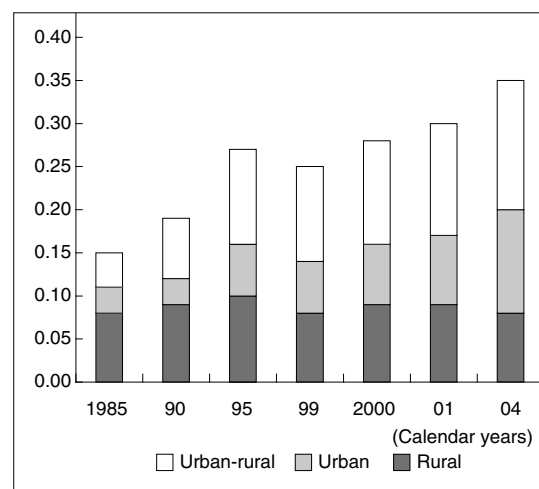
The same is true of the social insurance law. One of the key measures contained in this law is a

**Fig. 4 Gini Coefficient (National Basis)**



Source: Compiled using data from Chen and Hou (2008), Ravallion and Chen (2004), National Bureau of Statistics ([http://www.stats.gov.cn/tjsujia/zggq/t20070411\\_402398097.htm](http://www.stats.gov.cn/tjsujia/zggq/t20070411_402398097.htm))

**Fig. 5 Analysis of Income Inequality (Theil Index)**



Source: Compiled using ADB (2007)

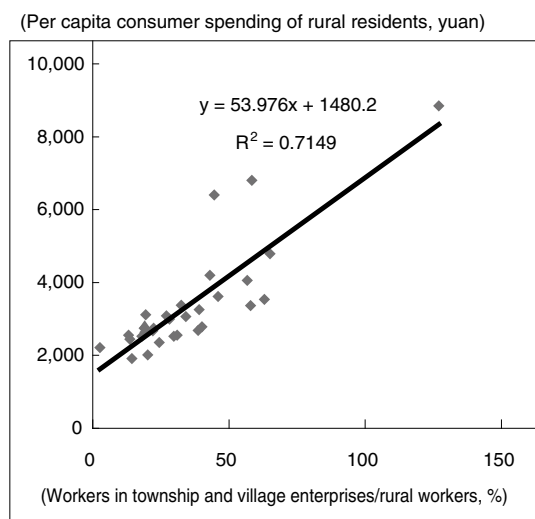
new old age pension insurance scheme. The cost of premiums for individuals will be reduced by increasing the subsidies provided by collectives (township and village governments, enterprises) and regional governments. There is an expectation that policy will help to lay the foundations for universal insurance coverage, since it will provide a stronger incentive to join the scheme and is seen as a way to end a vicious circle in impoverished regions, where the percentage of people joining pension schemes has remained low because a link between low premiums and low benefits. However, the apportionment of premium costs among individuals, collectives and regional governments will be determined according to the situation in each region. In a certain district in Beijing, the ratio will be 2:5:3. However, the capacity of collectives and governments to meet this cost depends heavily on the wealth of rural communities, which in turn depends to a large extent on the level of development of township and village enterprises (Fig. 6). For this reason, it would be difficult to apportion costs using the same ratio in impoverished inland rural areas. The new rural pension insurance scheme will probably help to reduce the gap in coverage rates between urban and rural areas. However, the scheme could also cause a fur-

ther decline in the relative status of impoverished rural communities.

Many observers have also expressed doubt about the extent to which the amended labor law will be put into effect. While this law has raised awareness of workers' rights, the financial crisis that began in the fall of 2008 has resulted in continual lay-offs and factory closures and the emergence of a buyer's market in coastal regions, where those rights were expected to be put into practice. In the first six months of 2009, there were 170,000 labor-related lawsuits, an increase of 30% compared with the same period in 2008. However, there are likely to be even more workers who are not in a position to complain about a deterioration in their working environments. The real effectiveness of the new law is about to be put to the test.

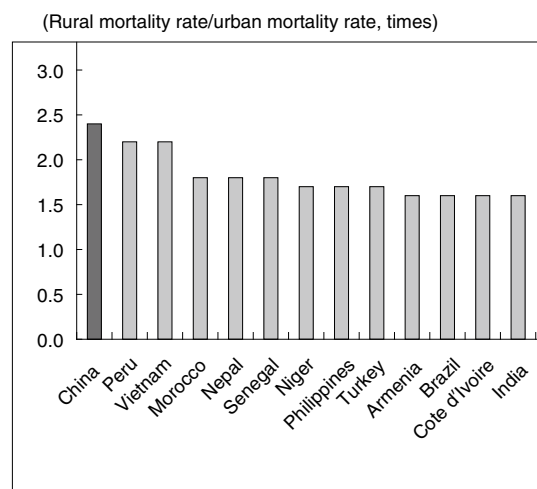
Finally, there are problems with the new prosperity index. The government deserves credit for including factors relating to "harmony" and "scientific development" in this index. However, because this index will be used as an indicator of progress toward the realization of these concepts, it needs to be based on data that reflect outcomes rather than inputs. For example, "harmony" in the health sector should be measured not according to the coverage ratio of the rural collective medical system, but ac-

**Fig. 6 Rural Wealth and Percentage of Workers Employed in Township and Village Enterprises (by Province and City)**



Source: Compiled using *China Statistical Yearbook 2008*

**Fig. 7 Urban-Rural Variation in Infant Mortality**



Notes: The figures for China are from 2007. The figures for other countries are from 1999-2006.

Source: *Chugoku Eisei Teiyo 2008* [Overview of Health in China 2008]

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cording to urban-rural variation in infant mortality, which is the highest in the world (Fig. 7).

## II. Economic Growth, Income Inequality, Social Instability

The efforts of the Communist Party and the government to create a “harmonious society” or build a society based on “scientific development” are not going according to plan. Social stability will depend to a large extent on whether continuing economic growth brings continuing expansion of income inequality, and on the role that the government can play in correcting any further increase in inequality. In Part II we will examine these questions on the basis of Kuznets’ theory about an inverted U-shaped trend. After highlighting a lack of social mobility as one of the reasons why income inequality leads to social instability, we will then look at the progress that China has made in dealing with this problem.

### 1. Economic Growth and Income Inequality

In Part I we saw that economic growth in China has tended to result in expanding income inequality. This appears to be a manifestation of the first half of Kuznets’ theory about the inverted U-shaped trend in income inequality. According to this theory, income inequality increases in the initial stage of economic growth but starts to reduce when a certain stage of growth is reached. It is an empirical rule based on studies of various Western countries in the first half of the 20th century.

There are many corroborative studies based on cross-country data that do not support this theory<sup>(7)</sup>, but these merely examined whether or not there was a correlation between economic growth and income inequality and do not provide a systematic explanation of the causes of inequality. Some studies indicate that the significant causes are not economic growth but other factors, including the rate of participation in education, the rule of law, and democracy<sup>(8)</sup>. However, these studies do not seem to provide a proper explanation of the

expansion of income inequality in China.

Corroborative research based on cross-country data may itself be problematic. Corroborative studies are based on the premise that if the inverted U-curve theory is universally applicable to every country, the same curve will appear when income levels and Gini coefficients are plotted on a cross-country basis. However, there is no guarantee that the shape of the inverted u-curve will be the same for every country. It seems hasty to discard the inverted U-curve theory simply because it is not corroborated by cross-country data.

According to Kurznet (Kurznet [1969]), the expansion of income inequality as a consequence of economic growth is caused by increased inequality within non-agricultural industries resulting from the migration of population to cities, and by a rapid increase in the relative importance of these non-agricultural industries. Several factors have been put forward to explain the reduction of inequality after a certain stage of development is reached. First, improvements in per capita productivity of agricultural workers reduce the productivity gap between industries. Second, there is a decline in the self-employed population, within which there is considerable inequality, and an increase in the employed population, which is less affected by inequality. Third, equality of opportunity is assured through the development of various systems, including inheritance taxes, income taxes and social insurance systems.

This theory still seems very convincing, and it may be useful to apply it to China. By looking at population movements and productivity levels in various industries, we will be able to ascertain whether China is still on the left side of the inverted U-curve in terms of income inequality, or whether it is approaching the top of the curve. Economic development has been accompanied by a population shift from rural to urban areas. The number of migrant workers, known in China as peasant workers (*nong-min-gong*), is thought to have reached more than 200 million by the end of 2008<sup>(9)</sup>. From the perspective of population movement, therefore, income inequality in China appears to be in the expansionary phase.

The question is whether or not the present phase



will continue into the future. We can surmise an answer to this question by analyzing the extent to which productivity varies between industries. Fig. 8 compares productivity in different industries. The productivity gap between primary and secondary industries began to shrink in 2004, in part because the supply of unskilled workers had become insufficient to meet the demand. However, there is still a significant productivity gap between primary industries and other industries. This indicates that there is still scope for further substantial population movement, and that there is a strong possibility that income inequality will expand further.

Caution is required when comparing China with other countries because of differences in the initial conditions. However, this view is supported by the fact that the percentage of the working population employed in agriculture is high for a country at China's stage of development (Fig. 9), and by the fact that that urbanization has occurred more slowly in China than in other developing countries (Miura [2006]).

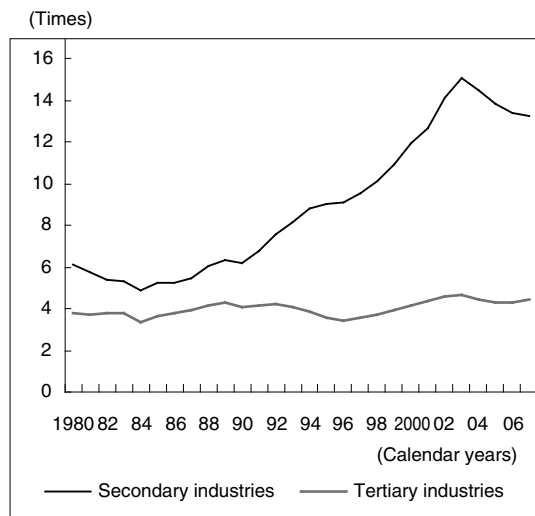
Productivity is not the only factor indicating that income inequality in China is still in the expansionary phase under the inverted U-curve theory. Another indicator is growth in the number of self-

employed people (*getihu*). The number of self-employed people in the rural sector has followed a downward trend since the second half of the 1990s, in contrast with the continuous growth trend in the urban sector. In 1993, self-employed people made up just 5.1% of the urban working population, but by 2008 this percentage had risen to 11.8%.

It is important to note at this point that although the number of people in employment has risen, this has not necessarily led to a reduction in income inequality. Between 1994 and 2004, the yearly income of government employees in Dongguan City, Guangdong Province increased by a factor of 4.3, from 8,000 yuan to 35,000 yuan. The income of workers in the clothing and leather industries rose only 1.6 times, from 6,000 yuan to 10,000 yuan (China Labor Bulletin [2006]).

The urban labor market is divided into two separate markets, one for formal sector workers (*zhigong*), and the other for non-*zhigong* workers. The percentage of urban workers in the *zhigong* category has fallen from 81.3% in 1993 to 38.1% in 2008, while the percentage of non-*zhigong* workers has climbed from 18.7% to 61.9% over the same period. Peasant workers (*nong-min-gong*) make up one-half of the non-*zhigong* work

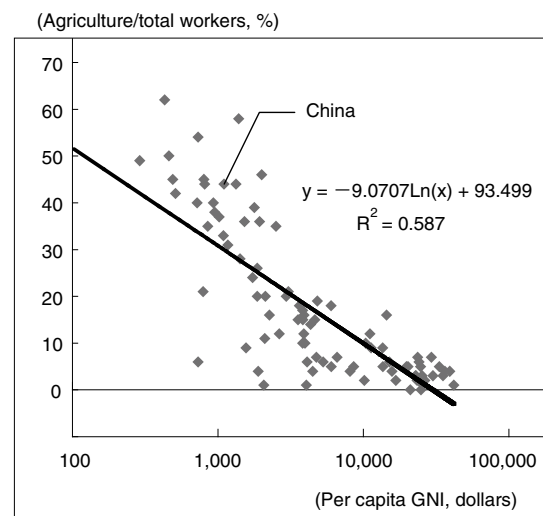
**Fig. 8 Productivity Differences by Industry (Primary Industries = 1)**



Notes: The figures are based on 1980 prices. Productivity in each industry was calculated as added value (1980 prices)/number of people employed.

Source: Compiled using *China Statistical Yearbook 2008*

**Fig. 9 Development Stage and Percentage of Workers in Agriculture**



Source: Compiled using World Bank, *World Development Indicators 2008*

force<sup>(10)</sup>. Instead of evening out incomes, growth in the employed population has instead caused a polarization of incomes.

## 2. Inequality and the Role of the Government

We next need to verify the final point made by Kuznets, which was that the development of various systems, such as inheritance taxes, income taxes and social insurance systems, ensures equality of opportunity and leads to the reduction of income inequality. To what extent can a government correct income inequality through progressive taxation and social security systems? In terms of initial income<sup>(11)</sup>, Japan's Gini coefficient has risen rapidly since the 1980s<sup>(12)</sup>. In terms of redistributed income<sup>(13)</sup>, however, it has remained quite low because of the redistributive effects of social security (Fig. 10).

Some economists believe that government measures to correct income inequality have also been effective to some extent in China. According to a study comparing the pre-transfer and post-transfer distribution of social benefits, such as pensions, health care and education, in urban areas (Gao [2006]), the government is contributing to the reduction of income inequality. The fact that income inequality is increasing is attributed to the large

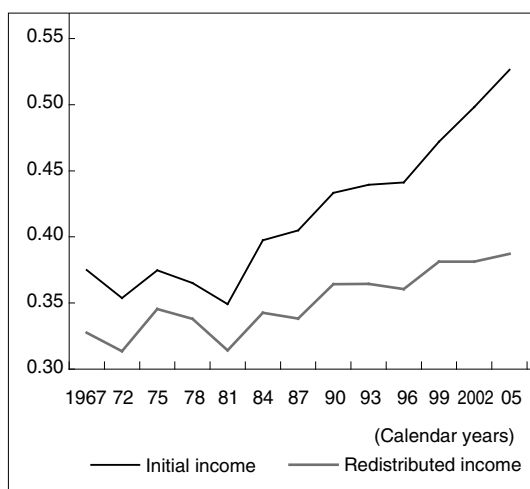
size of the pre-transfer income gap caused by the shift to a market economy (Fig. 11).

However, this study overestimates the government's contribution to redistribution. Pensions are said to account for 60% of social benefits, but pension recipients are limited to formal sector retirees, who appear to represent only a small percentage of total urban residents. The fact that pensions are treated as a major benefit despite this indicates that there is a sample selection problem, specifically that the sample does not include self-employed people or peasant workers.

When the role of redistribution in correcting income inequality is measured using household budget surveys, which have larger samples, we find that there is little effect. Fig. 12 shows Gini coefficients calculated using data that approximate initial income and redistributed income in the urban and rural sectors. There are no major differences between the coefficients for initial and redistributed income in either the urban or rural sectors.

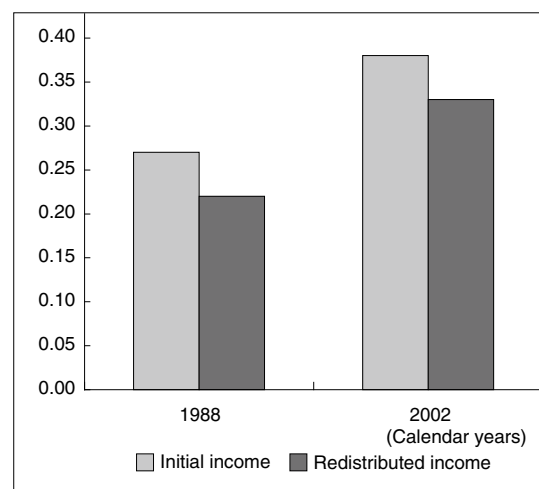
We need to be aware of the strong possibility that even this assessment may represent an overestimation of the government's role. Because peasant workers are excluded even from the household budget survey data used in Fig. 12, and because separate surveys are conducted for the urban and rural sectors, income inequality appears smaller than it is in reality. Budget surveys based on the

**Fig. 10 Japan's Gini Coefficient**



Source: Ministry of Health, Labour and Welfare, *Income Redistribution Survey, 2005*

**Fig. 11 Changes in Gini Coefficient Resulting from Redistribution**

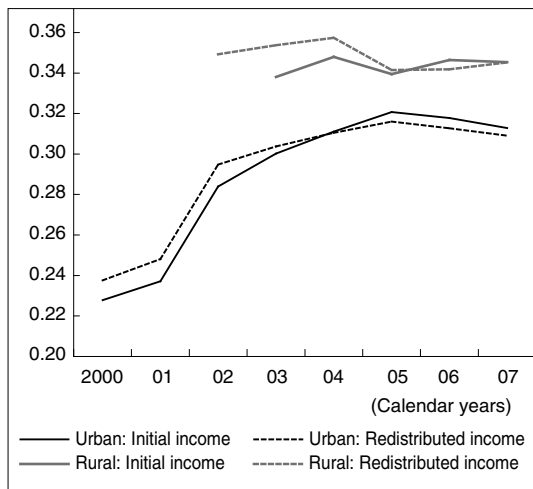


Source: Compiled using Gao (2006)

actual mixture of households would probably show that the government's taxation and social security systems are not correcting inequality but causing it to expand.

An empirical study was carried out to investigate the causes and direction of income inequality, using variables that included investment, trade, urbanization, unemployment, income transfers, social security, road and communications infrastructure, education, labor force movement, non-tax burdens and informal income (Wang [2006]). This study indicated income inequality was linked to factors other than income, including policy decisions, such as ① inappropriate privatization, ② income redistribution through progressive taxation and social security systems, or through public goods, such as education and infrastructure, and ③ corruption. The author concludes that the reduction of income inequality, as occurs in latter phase of the inverted U-curve theory, is unlikely to occur in the foreseeable future.

**Fig. 12 Gini Coefficients for Initial Income and Redistributed Income**



Notes: Based on the assumption that government intervention is reflected in transfer income, income was calculated as follows.  
 Urban initial income = gross income - transfer income  
 Urban redistributed income = disposable income  
 Rural initial income = net income - transfer income  
 Rural redistributed income = cash income

Source: Compiled using data from *Zhongguo Chengshi Shenghuo yu Jiage Nianjian Genianban* [China Yearbook of Urban Livelihood and Price Trends, Various Years], *Zhongguo Nongcun Zhuhu Diaocha Nianjian Genianban* [China Yearbook of Rural Household Surveys]

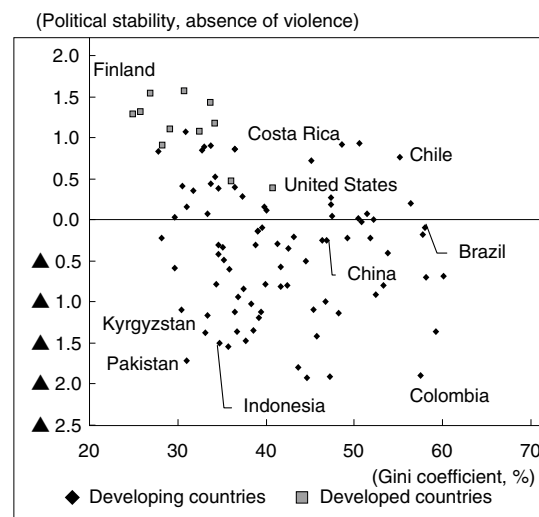
### 3. Inequality and Social Mobility

Economic growth generates strong pressure toward income inequality, but the government has no effective tools to correct this tendency. This is why social stability becomes an issue in China, regardless of how economic growth is achieved. In fact the problem seems to be proportionate to the level of economic growth.

However, there are countries that are socially stable despite income inequality, and others that experience instability even though there is little inequality. To understand the ways in which expanding income inequality influences social stability, we need to analyze the relationship between these two phenomena.

The figures plotted in Fig. 13 for the various countries represent Gini coefficients and the political stability and absence of violence index published by the World Bank. A higher figure indicates a higher degree of stability. The index encompasses a broad range of concepts, including the possibility of a coup d'état or terrorism. If we explore the relationship between this index and the Gini coefficient, using per capita national in-

**Fig. 13 The Gini Coefficient and Instability**



Notes: The figures for political stability and the absence of violence are averages for 2000-2007. Gini coefficients are averages for 2000-2005. Figures were plotted for 96 countries for which valid data were available.

Source: Compiled using data from *World Bank, World Development Indicators 2008, Governance Indicators 2008*

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come as the control, we find that the link between a high Gini coefficient and low political stability and absence of violence index exists only in developed countries. No such link is apparent in developing countries<sup>(14)</sup>.

For example, both Brazil and Chile are stable countries, despite the existence of major income inequality. The Gini coefficients of these countries have been among the highest in the world since the 1970s, yet neither has experienced continual instability during this period. At the other end of the scale are Pakistan and Indonesia, which are both affected by instability even though income inequality is minimal. The existence of countries with these characteristics appears to negate the general perception that countries with wide income inequality will become unstable (Alesina and Perotti [1994]). However, the high Gini coefficients of Latin American countries reflect systems that allow ownership of vast areas of land, while political instability in Pakistan and Indonesia is linked to terrorism caused by Islamic fundamentalism. Would a specific correlation between income inequality in social stability become apparent if these other factors could be controlled effectively, however difficult that may be in practice?

In China, the problem of income inequality appears to be the most important cause of social instability. The 2009 *Blue Paper on Society* includes the results of a survey of officials in the Ministry of Public Security. The top three problems identified as causes of social instability are income inequality, unemployment and corruption. It is reasonable to see income inequality as a cause of instability. The problem is that the degree of influence varies from country to country.

Why is there this variation in the degree to which income inequality affects social stability in different countries? One of the keys to this puzzle is social mobility. In countries where social mobility is unrestricted, income inequality will not lead immediately to instability. Conversely, societies with rigid class structures are likely to become unstable as dissatisfaction builds among people trapped in the lowest echelons of society. The degree of pressure toward social instability can perhaps be calculated as the multiplication of income

inequality and social immobility.

For example, while there is substantial income inequality in the United States, this is not necessarily a cause of social instability. As symbolized by the election of President Obama, there is a widely shared perception that equality of opportunity is a positive value. This serves as a breakwater against social instability. The question of whether or not social mobility is increasing has a major bearing on social stability. This question is the focus of intense interest in China, and there have been numerous surveys about social classes in recent years.

In Fig. 14, data from some of these surveys have been used to examine inter-generational social mobility by examining how fathers' occupations influence the careers of children. People with fathers who were government officials or business managers were chosen to represent the upper classes, and peasants to represent the lower classes. The figures shown for both of these cases represent ease of access to careers. A low figure indicates that the father's class has no influence on the child's class, while a high figure signifies that there is a strong possibility of class inheritance between generations.

Fig. 14 shows that a child whose father is a government official, business manager or company owner is highly likely to find work in the formal sector, and that the possibility of this career path has risen rapidly. The graph also shows that where the father is a peasant, there is a strong possibility that the child will work in the informal sector, and that the most likely outcome, regardless of the period, is unemployment. Given the expansion of income inequality and this lack of social mobility, there can be no doubt that pressure toward social instability is increasing.

### III. Are Warnings about Social Unrest Overstated?

While there can be no doubt that social unrest is increasing in China, few observers are predicting that China will slide into uncontrollable disorder in the near future. This suggests that the range of unrest that can be tolerated in China is quite wide,

**Fig. 14 Occupations of Children Where Fathers are Executives/  
Business Managers (Left) and Peasants (Right)**



Notes: Ease of access to careers = Actual result/anticipated result, anticipated result = (number of individuals gaining specified jobs/total sample) x number of fathers in specified jobs  
Source: Compiled using Lu, ed. (2002)

and that the critical point is further away than is generally believed.

In this section, we will first examine the nature of social unrest and the mechanisms that cause it. We will then analyze statements and data suggesting that warnings of social unrest are overstated and consider whether or not these will continue to push back the critical point.

## 1. The Mechanisms of Social Unrest

What situations are likely to cause social unrest? In discussions about developing countries, the concept of unrest encompasses a wide range of factors, from crime, strikes and anti-government demonstrations to terrorism, coup d'états and civil wars. China's Ministry of Public Security places crimes that threaten social control and order in a separate category from ordinary criminal activities. That category consists of crimes relating to prostitution, gambling and drugs, together with "group activities that hinder the performance of official duties" (i.e., disturbances).

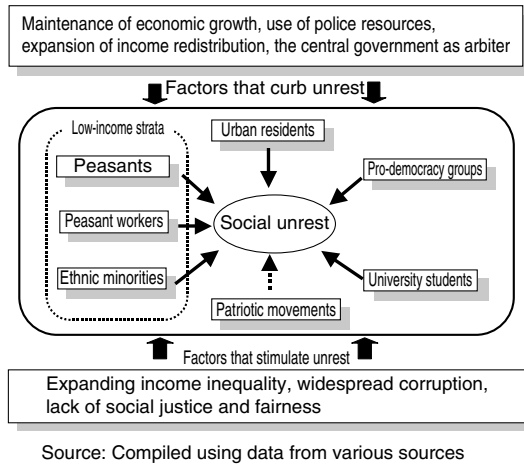
The government believes that the word "disturbance" has antisocial connotations and therefore uses the expression "group incident." A group incident is defined as a situation in which 10 or more people gather together and engage in activities that

contravene laws and regulations, disturb social order, threaten public security and the physical safety of the public, and violate public or private property (Watanabe [2009]). It is not clear whether there is any difference between "group incidents" and "group activities that hinder the performance of official duties," but it is probably safe to assume that they have roughly the same meaning.

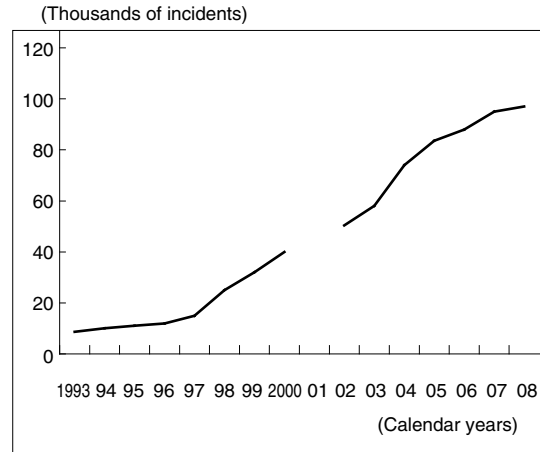
American experts (Keidel [2006], Lum [2006], Tanner [2005]) treat social unrest and disturbances as synonymous, and the Japanese media generally take a similar stance. In China, information is rigidly controlled and monitored, with the result that disturbances never start as large-scale events. They are believed to result from the escalation of protest activities against the government or companies, or from the expansion of confrontations between small groups and security forces or other groups.

The groups that trigger these events and their reasons for taking action can be divided into a number of groups (Fig. 15). The first group consists of peasants, who engage in confrontations with the government and companies over excessive tax levies, the expropriation of land for development, environmental pollution, and other issues. Urban residents make up the second group, which is characterized by frequent confrontations with the government over issues that include the expropriation

**Fig. 15 Mechanisms of Social Unrest**



**Fig. 16 Group Activities that Hinder the Performance of Official Duties**



Notes: Keidel (2006) defines a group as a gathering of 15 or more people. The figures for 2006 and subsequent years were calculated by subtracting crimes relating to prostitution, gambling and drugs from the cumulative totals of crimes against social order in the first 10 months of each year. No data are available for 2001. Source: Compiled using Keidel (2006) for the period up to 2005, and the *Blue Paper on Society* for subsequent years

of land, and with companies over dismissals, non-payment of wages, working conditions and environmental pollution. Urban workers can be divided into people with urban family registers, and peasant workers who are not registered residents. Confrontations involving the third group, ethnic minorities, are triggered by sovereignty issues.

Although their activities are not classed as disturbances, the intelligentsia, including pro-democracy opposition groups and university students who sympathize with their aims, are also seen as a group that causes social unrest. Patriotic movements can also be classed as a source of unrest because of their involvement in anti-Japanese campaigns and campaigns targeting foreign-owned companies. While these movements are not anti-government, there is a risk that they will recruit large numbers of supporters via the Internet and expand their activities beyond the level anticipated by the government.

The government and the Communist Party aim to curb unrest by ① maintaining high economic growth, ② using police resources (tightening of information control and monitoring, early intervention by security forces), ③ expanding income redistribution and ④ strengthening the central government's role as arbiter<sup>(15)</sup>. They also stimulate unrest through ① increasing income inequality, ② widespread corruption, and ③ a lack of social justice and fairness. The incidence of disturbances has risen dramatically since the second half of the

1980s (Fig. 16). This suggests that the range of factors that trigger confrontations, such as land expropriation and environmental pollution, has expanded, and that factors that stimulate unrest have had a stronger effect than those that curb unrest.

## 2. The Critical Point is Still Far Away —Stability in the Midst of Instability

Few would dispute the view that unrest is increasing in China. However, there is little support for claims that unrest is nearing the critical point. Results from the numerous social surveys that have been implemented over the past few years paint a similar picture. The following is an overview of observations and data on this topic.

First, Lum [2006] states that China is unlikely to lapse into uncontrollable turmoil because groups that cause disturbances are prevented from forming links with groups in other regions or with other agendas by information controls and monitoring. There is considerable evidence to support this view, including the fact that the 20th anniversary of Tiananmen Square incident in 2009 simply confirmed

that students have little interest in politics<sup>(16)</sup>.

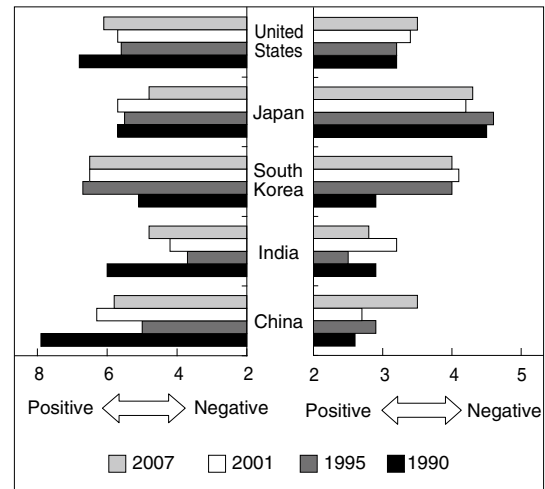
Second, China is a highly competitive society with a high tolerance for inequality. The World Value Survey characterizes China as highly competitive and more tolerant of inequality than Japan, India or the United States (Fig. 17).

Tolerance for inequality and a strong commitment to competition can be attributed to recognition of the social mobility benefits of education. According to the *Blue Paper on Society* for 2007, China's poor believe that the affluence of wealthy people results from their high level of education. Education is seen as the most effective tool for moving into a higher social class, and there is a perception that education has the potential to reverse income inequality.

Of course, reality is harsher than this. Based on the overall picture of social mobility that emerges from Fig. 14, China is clearly ceasing to be a society in which effort brings rewards. This perception is difficult to correct, since the comparisons are based on mobility within classes, not between classes. People in the lower classes will remain tolerant of inequality as long as there is evidence of upward mobility.

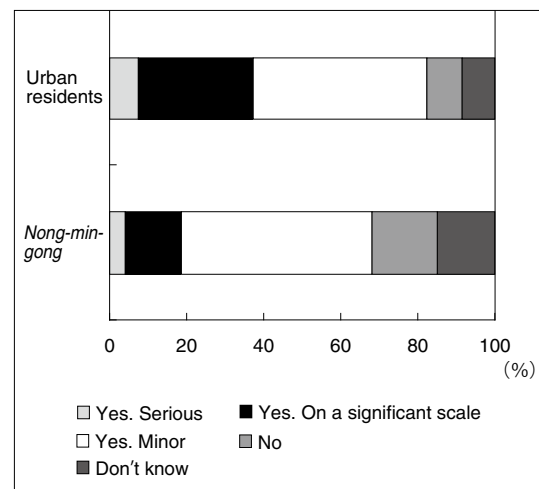
Third, the situation is not serious enough to justify predictions of class conflict. Participants in one social survey (Li and Li [2007]) were asked to indicate if there were conflicts of interest between social groups. Among both peasant workers (*nong-min-gong*) and registered urban residents, those who answered in the affirmative and thought the conflicts were "serious" or "on a significant scale" were outnumbered by those who gave a negative response or indicated that conflicts were "minor." There is also evidence that the *nong-min-gong* are more optimistic than registered urban residents (Fig. 18). A study comparing satisfaction levels among *nong-min-gong* and registered urban residents (Sonoda [2008]), produced data indicating that satisfaction was higher among the *nong-min-gong*. Both sets of data suggest that caution is required when attempting to portray the *nong-min-gong*<sup>(17)</sup> as a source of unrest.

**Fig. 17 Attitudes to Income Equality (Left) and Competition (Right)**



Notes: Based on decile assessments  
Source: Compiled using data from the World Value Survey website

**Fig. 18 Are There Conflicts of Interest between Social Groups in China?**



Source: Compiled using Li and Li (2007)

### 3. The Medium-Term Outlook

The 2009 *Blue Paper on Society* included the result of a questionnaire survey of Ministry of Public Security personnel. The 4.2% of respondents who thought that public order would worsen compared with the situation in 2009 were heavily outnumbered by the 32.2% who predicted improvement and the 48.3% who expected the present situation

to continue<sup>(18)</sup>. The Ministry of Public Security does not expect society to become more unstable. The reasons for this view have not been revealed, but it is perhaps necessary to think of unrest as a process occurring in several stages, and to see the number of disturbances as simply one factor determining the stage that has been reached.

Is unrest in China likely to reach a critical point? The answer to this question depends on whether or not the critical point will continue to move further away, based on the views and data described in the previous section. As observed below, the social environment on which those views and data are based is changing rapidly, creating a situation in which the Communist Party and the government will no longer be able to rely on the continuation of the status quo.

First, if information technology continues to spread and immigration becomes commonplace, it will become increasingly difficult to prevent links among different groups using reactive measures, such as information control and monitoring. The prevention of links has hitherto been an effective way to limit unrest, but we must assume that the effectiveness of this approach will gradually decline in the future.

Another source of concern is the growing scale and extremism of protest activities (Lum [2006]). The expanding scale of these activities reflects the spread of the Internet and mobile telephones, both of which have made organization easier. The trend toward extremism is also linked to the growing scale of these activities, which creates an environment in which crowd psychology can operate more readily.

When disturbances occurred in the Xinjiang Uighur Autonomous Region in July 2009, Chairman Hu Jintao cut short a visit to Italy, where he was attending the Summit, and returned to China. This unexpected behavior was a sign that the Communist Party and the Government were taking this problem more seriously than indicated by stories in the foreign media.

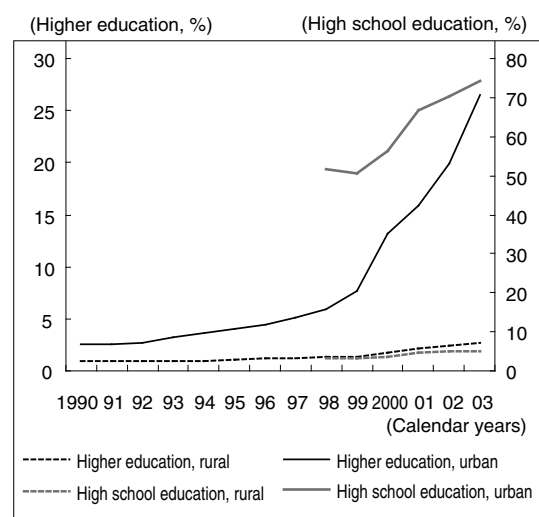
Second, the Chinese people's tolerance for inequality and their strong commitment to competition are expected to weaken rapidly. An empirical study undertaken to provide a rigorous analysis of

the link between education and income levels found that people in high-income positions gained those positions not through education, but simply through the influence of family attributes, such as the educational levels and incomes of parents. In other words, the income benefits of education are not as great as is generally believed (Miura [2008])<sup>(19)</sup>. Given the declining quality of higher education and the employment problems of university students, the correction of the excessive value placed on the social mobility benefits of education is unlikely to take long.

A more serious issue is the emerging problem of inequality of opportunity in higher education. In 2003, only 2.7% of rural students advanced to higher education, compared with a 26.5% ratio for urban students. The difference between the two ratios has widened from 2.6 times in 1990 to 9.8 times (Zhong and Liu [2006]) (Fig. 19). Another study focusing on the family backgrounds of university students revealed a decline in the number of children of peasants and workers and an upward trend in the number of children of government officials (Lin and Xun [2009], Yang [2006]).

In January 2009, Premier Wen Jiabao expressed concern about this problem at a state conference for science education leaders. He remarked

**Fig. 19 Percentages of Students Advancing to High-School and Higher Education**



Source: Compiled using Zhong and Liu (2006)



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that when he was at university, 80% of students were from rural areas, but that the percentage had dropped dramatically in recent years<sup>(20)</sup>. Chinese society is tolerant of inequality and highly competitive. However, it would be overly optimistic to assume that these qualities will continue to curb the growth of unrest.

Third, there is the problem of class conflict. Peasant workers (*nong-min-gong*) either do not see this as a serious problem or appear to be unconcerned because of their level of satisfaction with living standards. As with data relating to the income benefits of education, this pattern appears to reflect the fact that satisfaction levels are not based on comparisons between classes, but rather on comparisons within the same class or with the past. Recent advances in brain science indicate that satisfaction and the opposite emotion, envy, are engendered by comparisons between oneself and people in a similar situation (Takahashi, Kato, Matsuura, Mobbs, Suhara and Okubo [2009]).

In Part I, the fact that *nong-min-gong* are more satisfied with their living standards than urban residents was attributed to personal attributes, such as marital status. The same pattern has been observed in relation to levels of work satisfaction among *nong-min-gong* and registered urban residents (Heywood, Siebert and Wei [2009]). We should perhaps conclude that the anticipated correlation between satisfaction and social stability does not exist.

In fact the correlation between satisfaction and social stability is more likely to become apparent in the future. Migration patterns are changing<sup>(21)</sup>. In addition to the growing scale of the population shift from rural to urban areas, rural people are staying longer in the cities, and there has also been an increase in migration of entire families away from rural communities (Yan [2007]). As a result of these changes, *nong-min-gong* will increasingly see themselves as urban residents, and inevitably the range of people with whom they compare themselves will expand to include registered urban residents. As this tendency becomes more pronounced among city-bred people with rural household registers, it will become possible to compare levels of satisfaction in a real sense.

This attitudinal change is already being manifested in social surveys. In the social survey from which the data in Fig. 18 were quoted, respondents were asked about class conflicts in the future as well as in the present. The reverse pattern emerged, with positive responses, such as “Possible” and “Definitely” outnumbering negative responses such as “Unlikely” or “Never”<sup>(22)</sup>. It is possible that the way in which *nong-min-gong* view class conflicts will change significantly over time.

#### **IV. Several Scenarios—Growing Uncertainty about the Future**

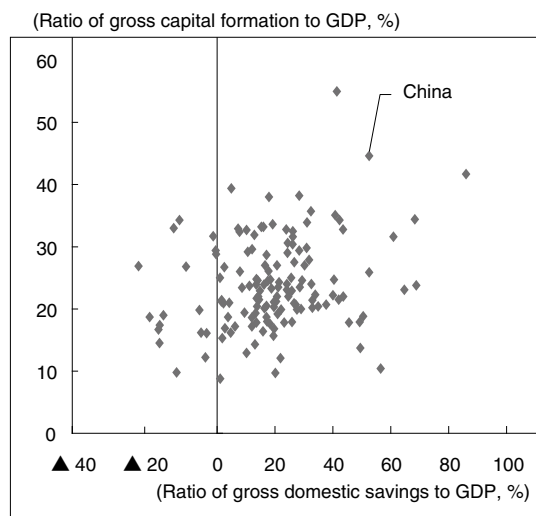
How will the Communist Party and the government cope with a society that is increasingly affected by unrest? In Part IV we will put forward a number of portfolios and examine their potential for realization.

##### **1. Maintenance of 8% Growth, Increased Monitoring**

The first scenario is the continuation of the status quo. There is a strong possibility that the government will opt for this scenario, since the core policies involved, such as the maintenance of 8% growth and the reinforcement of controls and monitoring, could all be readily put into effect. The use of police to deal with frequent disturbances would draw criticism from the international community, but China could avoid isolation simply by dropping hints about the impact on opportunities for market entry or its role as the biggest holder of U.S. government bonds.

As noted in Part III, this scenario would eventually end in failure. An economic analysis produces a similar outlook. One reason for this would be China’s failure to shift to a growth model in which the economy is driven by consumption. The contribution of investment to China’s GDP is extremely high by world standards, and investment is the main driving force for growth (Fig. 20). A high investment rate is sustained by a high saving rate, which is in turn the product of the continuing expansion of income inequality and inadequate

**Fig. 20 Savings Rate and Investment Rate (2006)**



Source: Compiled using data from World Bank, World Development Indicators 2008

social security systems. This means that to maintain the status quo, the government would need to accept the continuation of the old growth model.

Also significant is the high level of growth that would need to be maintained. China was able to minimize the impact of the financial crisis, in part by spending an estimated 4 trillion yuan on measures to stimulate economic activity, and is expected to maintain growth of around 8% in 2009. During a visit to China in September, World Bank President Robert B. Zoellick raised the World Bank's forecast for China's 2009 real GDP growth rate from 7.2% to 8% and praised China for its contribution to the early recovery of the world economy.

However, the 8% growth target was based on the 7.5% average annual growth rate stipulated in the 11th 5-year Plan (2006-2010). Because the target is an average for the period, a temporary fall below 7% should be acceptable. Even if growth slows, China will be able to transfer the responsibility to the United States. Despite this, the Communist Party and the government have adopted the maintenance of 8% growth as a political target. One reason for this may be their inability to predict the impact of a major decline in the growth rate on social stability.

A lower growth rate would have some effect on

the wealthy through lower share and real estate prices, but the impact on peasants and *nong-min-gong* would be enormous. Because most people in these groups are excluded from social security systems, a lower growth rate would lead directly to a decline in living standards. The export slump is believed to have resulted in job losses for 20 million *nong-min-gong*. In this situation, the Communist Party and the government may well have wondered if they were about to share the fate of Indonesia's Suharto regime, which lost its legitimacy under the impact of a sudden rise in social unrest triggered by an economic slump.

Maintenance of the status quo is not a desirable policy option, and it is uncertain how long such a policy could be sustained. The Communist Party and the government need to find an alternative to the maintenance of 8% growth and the tightening of controls and monitoring. That alternative policy is the creation of a "harmonious society" through the reinforcement of redistribution policies.

## 2. Increased Redistribution

The second scenario calls for the strengthening of redistribution systems. In the 11th 5-Year Plan, the Communist Party expressed its commitment to an increased emphasis on social equity, and its determination to ensure that all citizens would share the benefits of reform and development. In the past, benefit-sharing initiatives have consisted mainly of government-funded development investment, as symbolized in the Great Western Development Strategy. However, in recent years emphasis has also been placed on policies that directly affect the finances of farming households, such as the abolition of agricultural taxes, the introduction of free compulsory education, the provision of subsidies on electrical appliance purchases, and the expansion of social security coverage. However, as evidenced by the fact that there has been no reduction of urban-rural income inequality, the only effect of these policies has been to create a public impression that the Communist Party and the government are working hard to build the "harmonious society." One of the factors that is hindering efforts to raise rural incomes is

the small area cultivated per farming household compared with farms in other Asian countries (Fig. 21). The realization of the “harmonious society” concept will require a fundamental change in the shape of rural communities. The most effective redistribution policy would be to expand and modernize farms by encouraging people to leave agriculture through the abolition of the household register system and the removal of restrictions on the disposal of farmland.

In October 2007, a new property rights law came into effect. This law, which required 14 years of effort from drafting to adoption, represents an important step toward the easing of restrictions on the disposal of farmland. It seeks to put an end to a spate of compulsory farmland expropriations by regional governments, by stipulating that peasants have contract management rights (usage rights) over land. This measure paves the way for the distribution of usage rights through contracting, swaps, sales and other methods (Kamada [2007]).

While the law does not allow private ownership of farmland, it is having the effect of encouraging people to move from rural to urban areas. It is estimated that by the end of 2007, 14.8% of contracted land in Guangdong Province had been distributed<sup>(23)</sup>. The transfer of usage rights signifies a shift away from agriculture (Chen [2009]), while

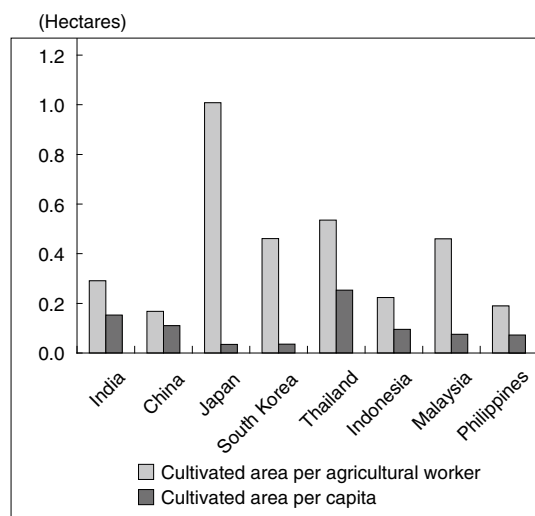
the reduction of the rural population brings benefits in terms of farm expansion and modernization. In October 2008, the Communist Party returned to this issue with its “decision on a moderately serious problem affecting progress on rural reform.” This decision further stimulated the liquidation of farmland.

However, it is still uncertain whether peasants will actively choose to sell their rights. The problem is that the reform of the household register system, which should have proceeded in tandem with land reforms, has fallen behind schedule. At the end of 2008, 13 provinces and cities, including Hebei Province and Liaoning Province, reportedly moved to abolish the household register system<sup>(24)</sup>, indicating that the reform process had started to accelerate. In reality, however, progress remains patchy. For example, when a senior official of the National Bureau of Statistics stated that the abolition of the household register system was an inevitable sign of the times, the Bureau itself placed an announcement on its official website stating that the official’s comment was merely personal opinion<sup>(25)</sup>.

At present there are no indications that major coastal cities, such as Shanghai and Beijing, plan to abolish the household register system, and the geographical spread of the reform process remains limited<sup>(26)</sup>. Furthermore, the current reforms fall far short of the image created by the word “abolition,” and their content casts doubt on whether any progress is being made.

In Hubei Province, for example, it is reported that the cities of Wuhan, Xiangfan and Huangshi were chosen to pilot a scheme based on the removal of the distinction between rural and non-rural household registers, and the replacement of this categories with the single classification of “resident of Hubei Province” (Kwan [2005]). However, Hubei Province still operates the basic health insurance system for urban workers and the new rural cooperative health insurance system. This shows that the abolition of the household register system is a reform in name only and has been implemented in isolation from related systems, such as social insurance schemes. Even if peasants sell their land usage rights and move to the city, they cannot become urban residents.

**Fig. 21 Farm Areas (2002)**

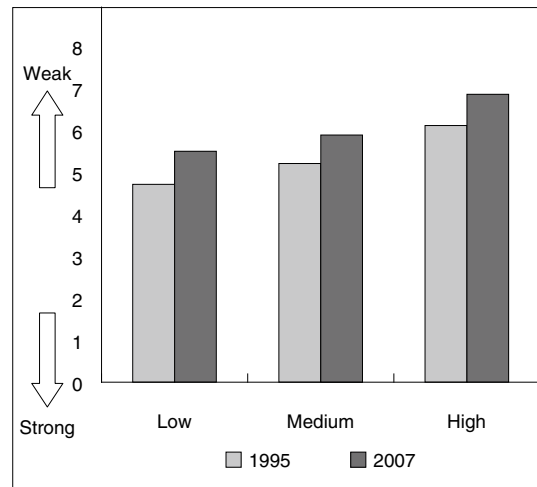


Source: Ministry of Economy, Trade and Industry, *White Paper on International Trade 2007*

One reason why the Communist Party and the government cannot move to abolish the household register system in earnest is because the system provides important advantages. It prevents peasants and peasant workers (*nong-min-gong*) from being compared with registered urban residents, and it impedes rapid urbanization. The system is also helps to foster social stability by using the rural sector as a buffer against unemployment. It even helps to maintain China's competitiveness by ensuring the continuing availability of cheap labor through the replacement of young workers. It is possible to argue that the abolition of the household register system would foster harmony and enhance social stability, or that competitiveness would benefit from the resulting increase in labor mobility. However, it is obvious to everyone that the costs and risks involved would be substantially greater than the cost of maintaining the current system.

The Communist Party and the government have also held back from abolishing the system because of the anticipated backlash from people with urban household registers. Because the urban household register system excludes the *nong-min-gong* from education and social security systems in the cities, urban residents have been able to protect their own jobs and enjoy high-quality education and social security. These benefits would be significantly diluted if the abolition of the household register system gave peasants and *nong-min-gong* the same rights as people with urban household registers. Many city people take the view that the peasants have their own livelihood security in the form of land usage rights, and that their status has been improved by an upward trend in the minimum wage resulting from shortages of unskilled labor. From the peasants' perspective, however, these arguments appear to be nothing more than excuses for avoiding cost increases for people with urban household registers. As suggested by the fact that the level of support for income equalization varies subtly according to the level of education (Fig. 22), the abolition of the household register system would throw value differences that have not been obvious in the past into sharp relief. There is a risk that these differences could escalate into confrontations between urban and rural

**Fig. 22 Effect of Level of Education on Attitudes to Income Equalization**



Notes: Low: completion of elementary school program or lower, medium: completion of secondary school program or lower, high: completion of tertiary education program or higher. Assessments are ranked in 10 stages from 1 to 10.

Source: Compiled using data from the World Value Survey

communities, between coastal and inland regions, and between different income strata.

The most rational way to foster a “harmonious society” would be to abolish the household register system and remove restrictions on the disposal of farmland. This approach would also contribute to democratization, since it would encourage people to vote with their feet. However, this remedy would have powerful side-effects. Redistribution policies have been limited to stop-gap measures because ultimately there is still a lack of consensus within the Communist Party and the government about whether or not the creation of a “harmonious society” is a task that must be undertaken without delay, regardless of the risk involved. Former Premier Zhu Rongji, who led a crackdown on corruption, is said to have asked someone to prepare 100 coffins, including one for himself. Today's leaders will need to show a similar degree of determination.

### 3. The Middle Class and Democratization

As the government runs out of options for pre-

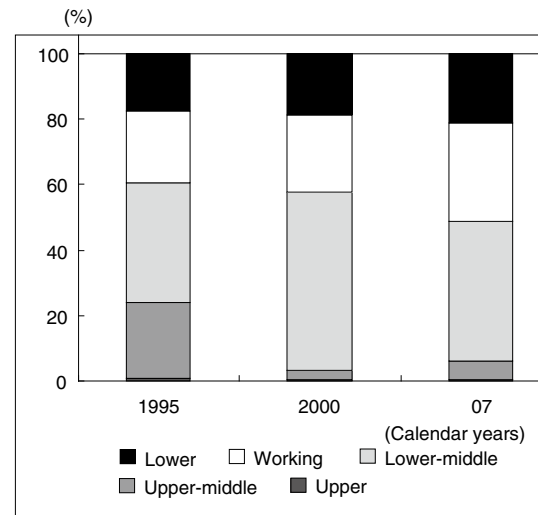
venting social unrest, some commentators have expressed the hope, based on the situation in Taiwan and South Korea, that the middle class, which has expanded as a result of economic development, and the pro-democracy faction within the Communist Party will instigate a shift away from the authoritarian system toward a more democratic structure (Kwan [2008]). So far we have focused solely on the influence of low-income groups, specifically peasants and the *nong-min-gong*, on social stability. In this section, we will examine the potential of this third scenario to become reality.

We first need to verify the size of the middle class. The definitions of the middle class provided by Lipset (Lipset [1963]) and Huntington (Huntington [1995]) are not entirely clear. However, there are two attributes that are common to both definitions: completion of higher education, and a certain level of income. In China, the percentage of students entering universities has risen dramatically since higher education became available to the masses, and China is now approaching the levels achieved by Taiwan and South Korea in the second half of the 1980s. However, while the overall income level has risen substantially, this has not produced an expanding center in the distribution of population across income strata. Instead, increasing income inequality has resulted in a polarized distribution, and there does not seem to have been a significant increase in the size of a middle class with both education and income.

This conclusion is also supported by class identity data. In China, the percentage of people in lower strata (“low” and “working”) increased in 1995, 2000 and 2007 (Fig. 23). This pattern is extremely different from the situation in Japan, where the reduction of income inequality in the 10 years leading up to the first oil crisis in 1973 (Otake [2005]) resulted in a decline in the size of the lower middle class and an increase in the size of the middle-middle class (Cabinet Office [2008b]), to the extent that people began to talk of Japan as a nation of 100 million middle class people.

Even if the Communist Party and the government begin to make real efforts to strengthen redistribution policies, leading to growth in the formation of a middle class with greater depth, it is

**Fig. 23 Class Membership Based on Declared Income**



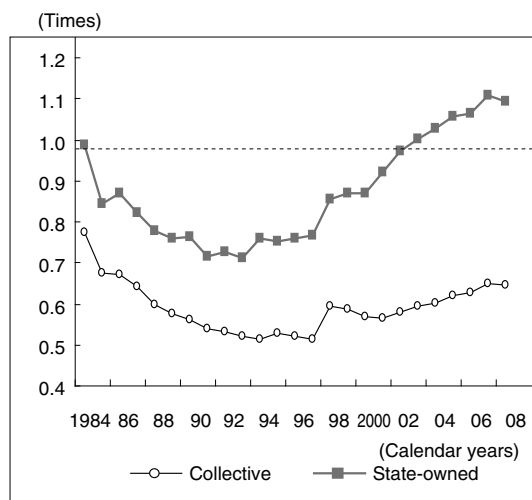
Source: Compiled using data from the *World Value Survey*

not clear whether that middle class would be capable of sharing the same values, as is commonly believed. Some studies state that the middle class in Asia differs from the image of the middle class in the West (Hattori, Funatsu and Torii [2002]), and that far from supporting democracy and continually seeking to exist autonomously from the state, the Chinese middle class has merged with the state (Sonoda [2007]).

This view is confirmed by the high rate of wage growth in the state-owned sector. The number of urban workers with known employment affiliations<sup>(27)</sup> reached 196.92 million in 2007. The state-owned sector is the biggest employer of this group with a share of 32.6%. Wages in the state-owned sector have been rising rapidly since 1998 (Fig. 24). The sector has strengthened its position as a beneficiary of reform, and it is possible that this has resulted in the division of the middle class according to the ownership format of the organizations to which middle class people belong.

We also need to recognize that even if China begins to move toward democratization, that will not necessarily result in greater social stability. As illustrated by the collapse of democratic governments in Latin America during the 1960s and 1970s, the stabilization of democratic systems is as difficult as the transition to those systems. A

**Fig. 24 Average Wage Inequality (Others = 1)**



Source: Compiled using data from CEIC

number of conditions need to be in place, including the rule of law, a free civil society, an environment that guarantees free competition among political parties, and the adoption of a democratic constitution (Linz and Stepan [2005]). We should perhaps conclude that Taiwan and South Korea are exceptions, and that it would be too simplistic to expect a similar process of democratization to occur in China.

## Conclusions

How can China maintain social stability while continuing to achieve economic development? This question has doubtless become an increasing source of anxiety for the Communist Party and the government, but there is no evidence that they have decided how to deal with the challenge. Instead they seem to be preoccupied with efforts to divert the people's attention away from class conflict.

China's greatest showcase was obviously the Olympic Games in August 2008. In October 2008, the Chinese government launched the Shenzhou VII space craft and ran live nationwide television broadcasts showing an astronaut spacewalking and waving the Chinese flag with the Earth in the background<sup>(28)</sup>. In October 2009 China will celebrate the 60th anniversary of the People's Republic by stag-

ing the first military parade in Beijing for 10 years.

These demonstrations of the unifying power and solidarity of the state provide a satisfying boost to the self-esteem of the Chinese people. The resulting sense of national solidarity and awareness of China's status as a major power are likely to provide a foundation for future economic development. However, major national events cannot engender a permanent sense of solidarity and pride in China's status as a world power. It is also important to recognize that these changes in national perceptions may not always have a positive effect.

When the Chinese people look at their own circumstances, there is a risk that their awareness of China's status as a major power will become a mechanism that amplifies their dissatisfaction with the Communist Party and the government. While economic growth and stronger monitoring and controls may be prerequisites for social stability, they are not the only requirements.

How can China turn its "harmonious society" slogan into reality? The key factors will be the provision of equality of opportunity through the reinforcement of redistribution systems, and the creation of a social environment in which people believe that hard work will be rewarded.

Everything that China needs to do to create its "harmonious society" was included in the 11th 5-Year Plan and the report to the 17th CCP Congress. Despite this, there seems to be no evidence of progress. As long as it continues to emphasize inputs in its policy decisions and administration, China will never be able to escape from this impasse. To build its "harmonious society," China will need to sweep away sacred cows and bureaucratic vested interests, identify what needs to be done, and establish new policy-making and administration systems under which assessments are based on outcomes.

Is China aware of these priorities? How will it provide the necessary leadership? Although time is running out, it should still be possible to rebuild a society that is moving toward increasing unrest. China's ability to maintain continuing growth and stability will depend on the acumen of the Hu Jintao administration and the fifth-generation leadership that will succeed it.

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## End Notes

1. The prosperity standards created by the government in 1991 set goals based on 16 items in five categories: ① per capita GDP, ② material standard of living, ③ national character, ④ spiritual standard of living, and ⑤ the living environment (Kwan [2003]). Unfortunately, the government has never revealed the extent to which the prosperity standards were achieved. There are three reasons for this. First, the standards were created at three levels: national, urban and rural. Second, there are no clear criteria for the integration of assessments of each item. And third, the standards were revised in 1995. Information about the 1995 prosperity standards at the national, urban and rural levels can be found on China Net (<http://www.china.com.cn/chinese/zhuanti/254476.htm>).
2. According to an estimate by the National Bureau of Statistics of China (November 23, 2000), three-quarters of the people were making progress toward prosperity at the end of 2000 ([http://www.stats.gov.cn/tjfx/ztx/zjxk/t20020530\\_20814.htm](http://www.stats.gov.cn/tjfx/ztx/zjxk/t20020530_20814.htm)). This estimate was based on the national prosperity standards.
3. The aim of the West-East Electricity Transfer Project is to generate power in the west and transmit to the east. The South-North Water Diversion Project will move water from the Yangtze to northern China. The West-East Gas Transmission Project will supply natural gas from western China to eastern China. The goal of the Qing-Zang Railway Project is to build a railway line from Xining in Qinghai Province to Lhasa in the Tibet Autonomous Region.
4. For example, under the rural prosperity standards, for which detailed evaluation items have been revealed, new indicators include the coverage ratios for the rural collective medical scheme and the rural old age pension scheme (harmony), levels of satisfaction with village administration and safety (democratic and legal systems), progress toward the adoption of information technology (quality of life), and forest areas and agricultural water supplies (resources and the environment).
5. Similar studies have been carried out in Japan to ascertain which factors influence "happiness." Positive factors include ① being a female, ② having children, and ③ being married. Factors that have a negative impact include ① advanced age, ② unemployment, and ③ stress. (Cabinet Office [2008a])
6. Chouyang Diaocha Xianshi: Xibu Chengxiang Jiaoxue Zhiliang Chaju Lada [Sample Survey: Increasing Variation in Quality of Teaching in Western Cities and Villages] China Education Daily website, December 7, 2008 ([http://www.jyb.cn/Teaching/jysx/200812/t20081217\\_219009.html](http://www.jyb.cn/Teaching/jysx/200812/t20081217_219009.html))
7. For example, empirical analyses by the World Bank all indicate that economic growth has no effect on income inequality. More detailed information can be found on the World Bank website (<http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTPOVERTY/EXTPGI/0,,contentMDK:20263391~menuPK:577810~pagePK:148956~piPK:216618~theSitePK:342771,00.html>)
8. E.g., Barro (1999), Dollar and Kraay (2001)
9. Searchina, *Chugoku: Nominko ga 2-Okunin o Toppa* [China: Number of Peasant Workers Exceeds 200 Million], March 25, 2009 ([http://news.searchina.ne.jp/dispcgi?y=2009&d=0326&f=national\\_0326\\_028.shtml](http://news.searchina.ne.jp/dispcgi?y=2009&d=0326&f=national_0326_028.shtml))
10. The percentage of *nong-min-gong* workers in the urban employed population can be estimated from the number of workers not included in the state-owned, collective or private enterprise categories, or as the difference between category figures and the total. Using figures in the *China Statistical Yearbook* for 2009, this results in a share of 31.5%.
11. Initial income is the sum of employment income, business income, farm crop income, livestock income, financial income, home-work income, miscellaneous income and private benefits (remittances, retirement benefits, life insurance payments, etc.).
12. One reason for this rise in the Gini Coefficient is demographic aging. As the population ages, expanding inequality in initial income inevitably increase the contribution of pensions to the correction of inequality.
13. Redistributed income = initial income - taxes (income taxes, residential taxes, fixed asset taxes other than business-related taxes, motor vehicle taxes) + social insurance benefits (health care, pensions) - social insurance premiums.
14. Political stability and absence of violence indices for developed countries =  $-9.473 - 0.853\text{GNI} (-2.912^*) + 1.278\text{Gini} (2.327^*)$ . Political stability and absence of violence indices for developing countries =  $-1.422 - 0.001\text{GNI} (-0.114) + 0.147\text{Gini} (0.881)$ . The figures in parentheses represent the value of  $t$ . A "\*" denotes a significance level of 5%.

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15. China has a petition system that allows people to report regional problems to the central government and seek remedies. People trust the central government far more than regional governments, and the central government maintains that trust by acting as arbiter between regional governments and residents. See Sonoda (2008) for an analysis of levels of trust toward the central government, regional governments and the mass media.
  16. In late 2008, a pro-democracy group published an “08 Constitution” on the Internet and demanded the abolition of one-party dictatorship. The Dalai Lama issued a statement welcoming this move. However, the 08 Constitution did not include any reference to self-rule for ethnic minorities. It is uncertain whether it will be possible to move toward closer cooperation between pro-democracy groups and groups seeking self-rule for ethnic minorities.
  17. These groups are referred to as “urban workers” and “migrant workers” in Li and Li (2007), and as “urban residents” and the “incoming population” in Sonoda (2008). For the sake of consistency, the terms “registered urban residents” and “peasant workers (*nong-min-gong*)” have been used in this article.
  18. This survey was probably conducted before the financial crisis. It is possible that a survey carried out after the crisis would have yielded different responses. However, China is expected to maintain growth of around 8% in 2009, and the findings can probably be regarded as a reasonable reflection of the normal situation.
  19. See Li, Pak, Ma and Zhang (2005). This study used panel data, including income levels and years of education for identical twins to investigate returns on investment in education. The rate of return when the twin effect was excluded was 8.4%, but it fell to 2.7% when the twin effect was taken into account. Since twins can be assumed to have the same family backgrounds, the net income increase resulting from education is only 2.7%.
  20. *Gaoxiao Nongcun Xuesheng Jianshao Chengxiang Jiaoyu Chaju Cong Xianxing Zhuanbian Wei Yinxing* [Rural University Student Population Shrinking—Rural-Urban Gap Shifts from Positive to Negative], Hunan Education website, January 15, 2009 (<http://www.hnedu.cn/web/0/200901/15111509406.html>)
  21. In Beijing, for example, 50% of the population inflow stays at least five years, and the average stay is close to six years. The percentage of migrants who relocate as families is now in excess of 40%. According to city government statistics, 60% of babies born in Beijing are the children of people who have moved into the city from other areas. See Recordchina, “‘*Koseki Seido ni Mondai Ari*’, *Senmonka ga Renmei de Ikensho—Chugoku*” [Problems in the Household Register System, Experts Issue Joint Position Statement—China], September 16, 2008 (<http://www.recordchina.co.jp/group.php?groupid=23970>).
  22. Specifically, 33.0% of urban residents and 38.2% of peasant workers (*nong-min-gong*) gave negative responses (“Unlikely,” “Never”) to the question: “Will class conflicts become more serious?” while 55.4% and 38.8% respectively gave positive responses (“Possibly,” “Definitely”).
  23. On October 29, 2008, the Xinhua News Agency website carried an article stating that management rights over 14.4% of farmland in Guangdong Province had already changed hands under the pilot scheme ([http://www.gd.xinhuanet.com/newscenter/2008-10/29/content\\_14768480.htm](http://www.gd.xinhuanet.com/newscenter/2008-10/29/content_14768480.htm)).
  24. An item on the Recordchina website on December 9, 2008, stated that rural household registers have been abolished in 13 provinces under China’s ongoing reform of the register system (<http://www.recordchina.co.jp/group.php?groupid=26566>).
  25. On September 11, 2009, the People’s Daily featured an item on its Japanese website, stating that the Bureau of Statistics had denied the existence of a plan to abolish China’s family register system (<http://j.people.com.cn/94475/6755156.html>)



26. In February 2009, Shanghai City announced a policy of granting household registers subject to people who met five conditions. First, the recipient must have held a certificate of residence for at least seven years. Second, the recipient must have been covered by social insurance for at least seven years during the period when he or she held a certificate of residence. Third, income taxes must have been paid during the period when the certificate of residence was held. Fourth, the recipient must be employed in a technical occupation at middle grade or higher or be an engineer with second-grade or higher qualification under the state occupational qualification system. The recipient must also be engaged in an occupation that matches that specialization. Fifth, the recipient must not have offended against the regulations under the family planning policies of the state or the city, have a record of convictions for public order offenses or more serious crimes, or a record of other undesirable behavior. However, only around 3,000 people meet the first requirement, and when the other conditions are taken into account, the number of eligible people becomes even smaller. It is estimated that 6 million of Shanghai's permanent population of 19 million do not have household registers in Shanghai. This information was obtained from a news item posted on the Japanese website of the People's Daily on February 23, 2009 (*Shanghai Koseki Shinseisaku, Kyojusho Shutoku 7-nen de Koseki Shinsei Kano* [Shanghai's New Household Register Policy Allows People Who Have Held Residence Certificates for Seven Years to Apply for Household Registers], <http://j.people.com.cn/94475/6755156.html>)
27. The total number of people in employment, including those whose employment affiliations are unknown, reached 239.5 million in 2007. Those who are not regarded as having known employment affiliations appear to be mainly peasant workers (*nong-min-gong*) working in the informal sector.
28. On October 9, 2008, the Japanese website of the People's Daily carried an article on the 30th anniversary of the reform and open door policy, describing how radio and television had changed the lives of the people (<http://j.people.com.cn/94475/94700/6512350.html>).

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