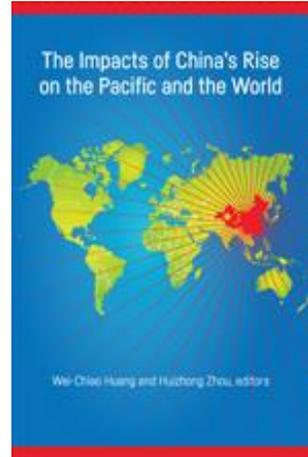


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# Why Exit Rights Are the Key to the Reduction of Urban-Rural Income Disparity in China

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# 6

## Why Exit Rights Are the Key to the Reduction of Urban-Rural Income Disparity in China

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Since the adoption of the “open up and reform” policy in 1978, China has reached many economic milestones. Until recently, it had maintained an average growth rate that was not only higher but also longer than almost any other nation in modern history (Naughton and Tsai 2015).

China is now the second-largest economy and is poised to become the largest in a not too distant future. It currently holds the largest foreign reserves, producing almost half of the world’s total steel and coal, and is the biggest producer of many important industrial products. However, China also has been facing some challenges. This chapter discusses the following issues:

- The change in China’s social structure has been lingering much more slowly behind that in its economic structure, resulting in relatively impoverished farmers and migrant workers, languorous rural communities, and an inefficient farming sector compared with its urban areas.
- Two institutional barriers will result in a middle-income trap through exclusive urbanization: the hukou system and the compulsory collective land ownership.
- The reasons it is impossible for China to develop a real land market under its Constitutional stipulation.
- The essence of market allocation: price mechanism.
- How to balance between efficiency represented by market allocation and control of externalities represented by urban planning and zoning.

Toward the end of this chapter, I propose how to reform the land tenure system in China.

## **SOCIAL STRUCTURE, ECONOMIC STRUCTURE, AND INCOME DISTRIBUTION**

As mentioned above, China's growth rate since 1979 has been ranked among the highest for the longest period for almost any nation in modern history—a great achievement of China's open and reform policy. However, as shown in the next two sections, its income disparity, particularly its urban/rural income ratio, has become one of the worst in East Asia, and perhaps in the world.

The World Bank (1993) defines the real economic miracle as growth with equity. There is truth in this definition. Many countries have achieved high growth, but few have achieved good income distribution. Among those having achieved relatively equal income distribution, most found their economic growth stagnated. Few nations have achieved high growth and relatively equal income distribution at the same time. For these few, they truly deserve to be crowned as economic miracles.

To achieve this, it is necessary to keep the sectoral share in the total labor force (defined here as the social structure) close to its sectoral share in total GDP (defined here as the economic structure). In other words, the social structure should evolve closely and in the same direction as the economic structure (Wen 2013).

In China's context, the share of agriculture in the total labor force should follow the trend of a declining share of agriculture in total GDP. To achieve this, the rural population must find their way out of the agricultural sector as its share in total GDP falls.

Developed economies have already reached a very low farming share in GDP (2–5 percent) and a correspondingly low farming share in total population (2–9 percent). It took several hundred years for them to achieve both. The other East Asian economies accomplished this much faster, in roughly 30–40 years, starting from the early 1960s after a land reform to provide farmers an equal footing in land distribution in the early 1950s. The rights to free land trading and free rural-urban migrating enabled Japan, South Korea, and Taiwan to not only achieve high

growth but also help prevent the worsening of their urban/rural income distributions. According to Oshima (1998, Figure 1), the values of the Gini coefficient in Japan, South Korea, and Taiwan never exceeded 0.4 during the period 1955–1995. Since then, their social structures have been evolving closely to the changes in their economic structure because without institutional barriers, farmers could freely trade their land and freely migrate to urban areas and to settle down there.

### **The Much-Worsened Income Distribution**

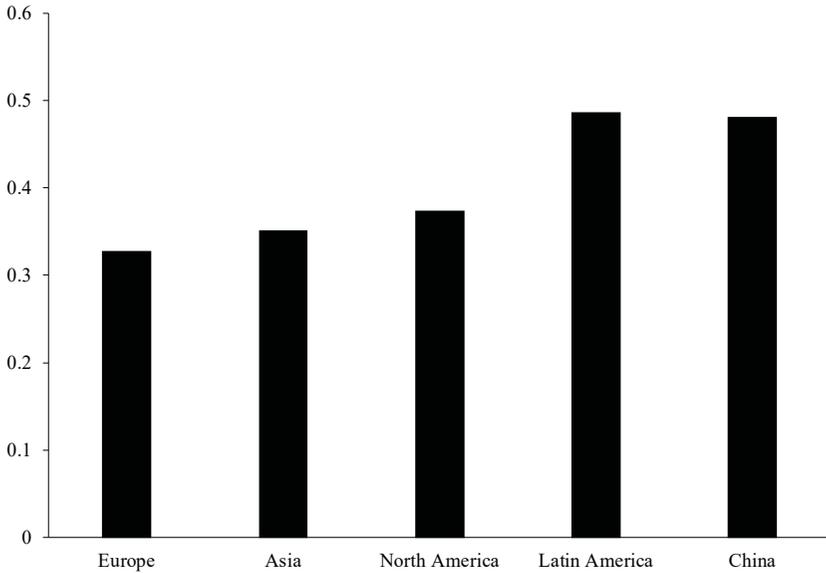
However, Oshima (1998, Figure 1) shows that, in sharp contrast, China started with a relatively low Gini coefficient value of around 0.2 in the mid-1960s; this value rose significantly above 0.4 by the mid-1990s. Since then, the income distribution has worsened until recently. According to Wildau and Mitchell (2016), the value of the Gini coefficient in China rose to 0.49 in 2012.

Han, Zhao, and Zhang (2016) put China's income distribution inequality in a more global perspective. As Figure 6.1 shows, the value of China's Gini coefficient (0.481) was very close to that of the Latin American average (0.486), and significantly higher than that of several other continents.

In addition to high values of the Gini coefficient, the urban/rural ratio in China is also very high. Based on China's official data (*Xinhua* 2017), the urban/rural income ratio was 2.72 in 2016.<sup>1</sup> Using this ratio, one can easily see that the average income of people living in rural areas was only about 36.76 percent of the income of those living in urban areas. This ratio was once as high as 3.3:1 in 2013; obviously this indicator is now looking better.<sup>2</sup> However, in terms of income gap, the urban-rural income disparity is still worsening—it increased from CNY19,758 in 2015 to CNY21,253 in 2016 (*Xinhua* 2017).

### **WHY CAN ONLY ENDOGENOUS URBANIZATION BEST ACCOMMODATE RURAL POPULATION?**

Urbanization provides the best channel of social mobility for the vast majority of the rural population in terms of their income and their

**Figure 6.1 International Comparison of Gini Coefficient Values**

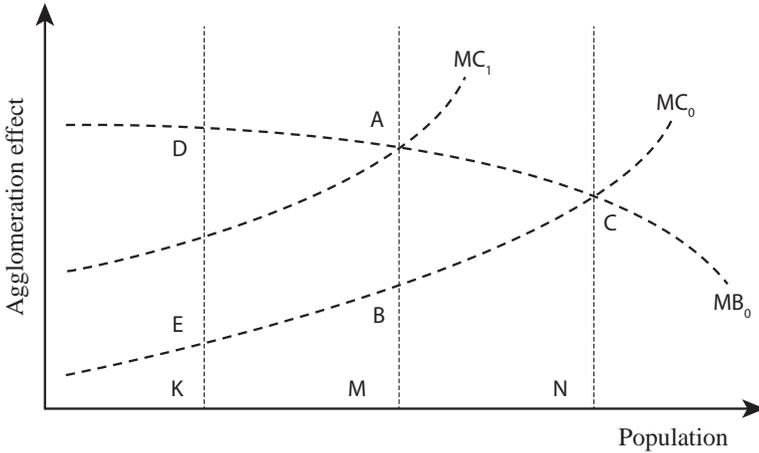
SOURCE: Han, Zhao, and Zhang (2016, Fig. 3.2).

upward movement along the social ladder. This is attributed to opportunities for greater specialization among these laborers, and to the ability to combine with the huge stock of capital and human capital agglomerated in urban areas.

When urbanization is endogenous—that is, driven by agglomeration effect, not simply by the government—then those who migrate to urban areas will be able to earn a higher income, and their children will have a better education than rural residents in general; otherwise, people will not choose to leave their native villages.

Figure 6.2 shows the determination of population size in an endogenously urbanizing city. The curve MB represents the marginal benefit of the agglomeration, and the curve MC represents the marginal cost of agglomeration, such as congestion, pollution, crime, and legal risks. The last one is conspicuously significant because of the insecure property rights and seriously distorted land and housing prices. The intersec-

**Figure 6.2 The Agglomeration Effect of Urbanization and the Deadweight Loss**



tion of the two curves C, or the corresponding point N on the horizontal axis, indicates the natural population size of the city. The space on its left, where the MB curve is still above the MC curve, implies that the net agglomeration is still positive, and the city can generate net gains by attracting additional migrants.

In other words, positive agglomeration effect can only be exhausted through trial and error by marginal migrants. To try out this population boundary of a city, rural residents must have the right to freely relocate themselves and to freely trade their land in case they decide to settle down in a city.

### **THE FIRST TRAP: HUKOU AND LOW SOCIAL MOBILITY**

Two institutions stand out as the most important barriers for the rural population to legally share urban prosperity and to accumulate wealth on equal footing: the hukou system and the land tenure system.<sup>3</sup> China's hukou system has resulted in urbanization of land much faster than the growth of the rural population.

The hukou system, represented by line KD, artificially limits the size of urban population to OK (O refers to the origin of the graph). Therefore, population measured by KN is excluded from the benefit of urbanization. The triangle CDE measures the deadweight loss caused by the hukou system. As mentioned above, for income distribution between urban and rural areas not worsening, the social structure should evolve in the same direction as a nation's economic structure and at a similar pace.

China's agricultural share in its total GDP has fallen to less than 10 percent, representing a great achievement for China in its effort to develop its economy. However, given this rapid drop in its agricultural share in GDP, it is more urgent to reduce the share of its rural population in its total population. It is not a good sign to see that more than 60 percent of its total population is still holding rural hukou, and around 48 percent of its total population is still living in rural areas.

Migrant workers are forbidden to legally settle in urban areas, although they are legally allowed to work there temporarily, and their children—some 60 million—are left behind in rural areas. The lack of educational opportunities in rural areas dictates that most migrant children will have limited human capital and will have low social mobility and low incomes in the future. If this situation continues, the prospect for China to improve its urban-rural income distribution is severely clouded.

## THE GOOD NEWS

The central government is gradually dismantling the hukou system. Although big cities will remain closed to most migrant workers, towns and small cities are urged to open up to rural migration. Only time will tell how effective and how soon China can ultimately eliminate the control over free migration and free settlement. It remains to be seen if the rural population in the Western region is allowed to freely settle in towns and small cities in China's prosperous coastal region. If such free migration and settlement between regions are allowed, the policy will represent a significant breakthrough.

## THE SECOND TRAP—LAND TENURE SYSTEM

Compared with the hukou system, the land tenure system is an even bigger trap for the following reasons:

- It gives local governments either a legal basis or an excuse by misinterpreting Article 10 of China's Constitution to take rural land for urban development.
- It prevents the growth of a true land market by prohibiting all land trading except by the government. The government under this system becomes a monopsony in buying farmers' land and a monopoly in auctioning the leaseholds to developers. The land price is seriously distorted, either inflated or suppressed.
- The monopolized and seriously distorted land markets have almost totally ignored the strong demand of migrant workers for affordable housing thus far. Affordable houses have been supplied by suburban farmers, but they are illegal under the land system, frequently facing demolition risk, making the permanent settlement of migrant workers impossible.

In the absence of a true land market, the current land system is still allocating land through issuing land quotas to provinces and cities, a practice typically seen under the Central Planning System. However, these land quotas are not based on equilibrium land prices, hence, excess supply and rampant shortage coexist without an automatic correcting mechanism. On one side, ghost towns, idling apartment buildings, and deserted industrial parks are emerging everywhere, especially in China's vast inland, but in its coastal areas, housing prices are skyrocketing; on the other side, most of the 2.6 hundred million migrant workers are living in shelters, slums, ghettos, or urban villages, which are being bulldozed by the local governments, aggravating the shortage of affordable housing.

Clearly the current land tenure system has shifted upward the marginal cost of living in an urban area by making housing and rental prices prohibitively expensive in coastal areas where most migrant workers could find jobs. Figure 6.2 shows that when the marginal cost curve shifts up, the size of the city population reduces from point N to point A, causing another deadweight loss measured by triangle ABC.

In summary, the current land tenure system has failed to allocate both rural and urban land efficiently, and it has failed to convert rural land into urban land efficiently and fairly. The last point will be explained shortly.

## **THE IMPOSSIBILITY OF DEVELOPING A TRUE LAND MARKET UNDER THE CURRENT CONSTITUTION**

Article 10 of China's Constitution makes it impossible to nurture a true land market. According to this article,

land in the cities is owned by the State. Land in the rural and suburban areas is owned by collectives except for those portions which belong to the State as prescribed by law; house sites and privately farmed plots of cropland and hilly land are also owned by collectives.

The State may, in the public interest and in accordance with law, expropriate or requisition land for its use and make compensation for the land expropriated or requisitioned.

No organization or individual may appropriate, buy, sell or otherwise engage in the transfer of land by unlawful means. The right to the use of land may be transferred according to law. All organizations and individuals using land must ensure its rational use.

Why is it impossible to develop a real land market under such Constitutional stipulations? First, let's review the definition of what is a market economy. According to the *MIT Dictionary of Modern Economics* (Pearce 1992, p. 267), "An economic system in which decisions about the allocation of resources and production are made on the basis of prices generated by voluntary exchanges between producers, consumers, workers and owners of factors of production. Decision making in such an economy is decentralized—decisions are made independently by groups and individuals in the economy rather than by central planners. Market economies usually also involve a system of private ownership of the means of production—i.e., they are 'capitalist' or 'free enterprise' economies."

Here, voluntary exchanges are most crucial to a market economy. However, the collective land ownership observed in China is established

on an involuntary basis. Rural collectives are not allowed to trade land among themselves, let alone the individual farmers. Even if a collective is totally inefficient or corrupt, or its leaders are abusive, members are not allowed to exit with their share of land to regroup a new collective on a truly voluntary basis. This means that collectives in China are compulsory against the market principle of voluntarism.

This system plays the function of permanently trapping those who want to leave their native village. They are not allowed to sell their land for market compensation. The rental market is underdeveloped and insecure because tenancy is not protected and leasing contracts are mostly verbal. Some peasants would rather keep their land vacant than return land to collectives or rent it out. This means that those who are determined to stay in the farming sector cannot steadily expand their land scales or significantly increase their incomes because of small-scale land operation. Because they do not own their land, they cannot use it as collateral when seeking financial services.

Therefore, the land tenure system in its current form is preventing the emergence of a real land market and consequently is preventing China's agriculture from being modernized and more efficient.

## **WHY IS EQUILIBRIUM LAND PRICE CRUCIAL?**

In the absence of a true land market, land prices are not generated by the forces of supply and demand. Therefore,

- We do not know the opportunity cost of each piece of land in order to put it to the most valuable (efficient) use.
- We do not know how to fairly compensate those whose land is taken away by the government.
- We do not know what should be the fair base for property, housing, and capital gains taxes. Without tax revenues from land properties, governments at all localities will continue to be addicted to land financing.
- We do not know how to allocate land of different uses in the correct proportions, because such price information can only be generated through arbitrage among land of different uses in land markets.

- We do not know whether the decision on setting 1.8 billion mu of arable land as a red line is scientifically based.
- We do not know whether estate-based mortgages are overleveraged, leading to housing bubbles and financial crises.
- Urbanization cannot be an endogenous process and cannot sustain because of the distortion in land and housing prices. The service sector is doomed to be underdeveloped because of the prohibitively high rentals.
- Ghost towns are mushrooming everywhere, when hundreds of millions of migrant workers desperately need affordable housing in the urban areas where they are working and living. Unfortunately, the misallocation of land and housing forces them to live in slums, shelters, and urban villages.

## **FREE EXIT RIGHTS ARE THE KEY**

Based on the discussion of the hukou and land systems above, we can see that it is urgent and necessary to thoroughly reform the two systems. In what follows, I want to focus on how to reform the current land system. To facilitate discussion, we divide all the land in China into three basic zoning categories conceptually in terms of their relationship to urbanization:

- 1) nonurban land—pure farmland and nonfarmland located far away from any urban areas, thus unlikely to be urbanized in the foreseeable future;
- 2) urban land—built-up land located in existing urban areas, thus fully urbanized;
- 3) suburban land—the farmland and nonfarmland located close to urban centers that is yet to be urbanized.

To nurture a true land market, the boundaries of all the plots must be clearly marked and recorded and their property rights registered before they can be traded at market without disputes. As a very encouraging development in this direction, local governments in China have been certifying land use rights of each farmer by delineating the borders of

each plot and its legal users. Obviously, the completion of this task is conducive to the establishment of a true open and competitive land market.

All the land, however, is either owned by the state (all the urban land) or collectives (almost all the farmland, including the suburban land). Individual farmers and urban citizens are not allowed to trade land. As we mentioned above, the land market in its current form is monopsonistic because the state is the only legal buyer of land, and also monopolistic because the state is the only legal supplier of urban land, far from being a typical land market that is open to everyone on a competitive level.

To widen participation in a land market to make it open and competitive, it is necessary to allow all plots to be tradable and all the farmers to participate as sellers or buyers of land. For this reason, the exit rights must be returned to farmers. As mentioned earlier, the current collective land ownership was imposed on farmers in the 1950s without necessary consent from farmers. Such imposition was not only a violation of voluntarism, a principle allegedly cherished by the Chinese Communist Party, but it also led to rampant inefficiency and frequent power abuse. In the spirit of voluntarism, farmers should be given the choice to stay in their current collectives if they like them, to exit to form new collectives on their own initiatives, or to return to family-based farming, which is the prevailing form of farming in the rest of the world. In other words, land privatization should be permitted if the party truly respects initiatives from farmers themselves. In this sense, certifying and documenting all the plots, pushed by the party and government, are correct and necessary steps toward this direction.

Above I divided all the land into three basic zoning categories. Now I briefly examine how a true land market will affect each of them. The long-standing mismatches between demand for and supply of land in different categories under the current land system will gradually be corrected. First, in urban areas, trading land with different uses will generate the information required for adjusting zoning by observing the relative prices of industrial, residential, commercial, and infrastructural land. By gradually easing the restriction on arbitrage among land of different uses, efficiency in allocating the existing urban land can be significantly improved. The excess supply of certain types of land, such as land originally designated as industrial, will be corrected by its fall-

ing price, and the undersupplied land of another type, such as the land originally designated as residential, will be corrected by rising price.

Second, by allowing suburban farmland to enter the land market by farmers' own initiative without changing zoning categories, China can avoid the possible chaotic situation that resulted from zoning violations. At the same time, local governments are not allowed to requisition suburban land unless for the pursuit of public interest. This will immediately lead to the short supply of urban land and increased land prices where urban areas are growing. The increasing price sends a signal to zoning authorities to speed up converting suburban farmland into urban land. The suburban land market is crucially important because it connects urban and rural areas, unifying the whole nation's land market, and also helps determine the natural border between rural and urban areas.

Third, more efficient farmers now can expand the operation scale of their farms through acquiring land at land market, and larger and modern farms will emerge from such transactions. Those who want to permanently migrate to urban areas will get compensated when they sell their land.

As stated earlier, to avoid disorder in land and housing markets, neither sellers nor buyers of any type of land should be allowed to change the current zoning categories of their land for the time being unless they first obtain approvals from the government. Under this condition, free land trade will not trigger a collapse of the land and housing markets. The fear of a possible collapse of land and housing markets is a main source of government hesitation in land system reform, a serious concern often cited by those who are opposed to the market-oriented land reform as a main argument. To remove government's fear, the current zoning categories should be kept for a certain period. The planning and zoning office should gradually adjust zoning categories by designating more land in suburban areas as urban land if the land price there is rising, and designating less land as urban land in urban areas where the land price is declining.

To reduce manipulation and interference in the land market, the government should stop acquisitioning land from local farmers for nonpublic purposes, as Article 10 of China's Constitution stipulates. This means that the role of planning and zoning in China should be fundamentally reformed; its rise in market economies was, and is still, a necessary response to the increasing need to address market failure,

represented by negative externalities and lack of public space due to urbanization (Wen 2014). However, in China, different from playing a complementary role in market allocation, as is seen in developed market economies, planning and zoning are a main remnant of its dismantled Central Planning System, and the government has been directly allocating land by arbitrarily determining land zoning and prohibiting non-state-owned land to enter land market with equal rights. It is worth noting that China's urban planning and zoning are selectively regulating market failures, depending on the type of land ownership, as the case of the urban village shows.

After establishing a true land market, the main target of planning and zoning should focus on filtering negative externalities and securing land of public use, not on filtering out the non-state-owned land. The thorny issue of urban villages and housing with few property rights will be resolved accordingly. Since they are either surrounded by or adjacent to urban areas, they should be part of urban land. Therefore, the local government has the same responsibilities to provide better planning and zoning regulation to all the urban villages and housing with few property rights, and better infrastructures such as sanitation, clean water, public toilets, schools, and clinics. In return, the owners in urban villages and owners of housing with few property rights have full obligation to pay all kinds of property taxes and capital gains taxes. If this proposal is accepted and enforced, the issue of urban village and housing with few property rights will be an issue of enforcing planning and zoning instead of an issue of discriminating against nonstate ownership.

Finally, the government should stop relying on land financing and instead levy property, housing, and capital gains taxes, in addition to issuing local public bonds to finance local infrastructure, using future land taxes to pay off. Land taxes are recurrent compared with one-time land financing. The latter will dry up sooner or later when urbanization nears an end.

## **CHINA IS AT A CROSSROADS**

China's urban-rural income disparity is among the worst in the world. Historical experiences from developed nations and from China's

East Asian neighbors eloquently demonstrate that to reduce this disparity, China must rapidly reduce its rural population. Only when a nation's social structure matches its economic structure can it achieve the goal of narrowing its urban/rural income gap. However, not only does 48 percent of China's total population live in rural areas while its agriculture's share in total GDP is less than 10 percent, but also 2.6 hundred million migrant workers remain unsettled in urban areas because of the hukou system, and because of the prohibitively high housing prices as a result of the current land tenure system.

As Figure 6.2 shows, the hukou and land systems are causing two types of deadweight loss—if they can be eliminated, then China can easily accommodate hundreds of millions of migrant workers and their families in urban areas. To make its urbanization more efficient and inclusive, China should focus on urbanizing its rural population rather than its rural land. If China decides to nationalize all the urban land, as advocated by some, then it will lose its last chance to develop a land market. If China is serious about nurturing a true competitive land market, it needs to give farmers the exit rights from compulsory collective land ownership and legalize land trading as long as the land use is not changed by users themselves.

China should also unify its land market nationwide. To avoid permanently fragmenting its rural land market, it should not consolidate the exclusively community-based collective land ownership. China should also abolish its hukou system as soon as possible. Only when it implements these two reforms can the country accelerate the absorption of rural surplus labor. Such an endogenous urbanization will soon significantly improve its urban-rural income disparity, as the experiences from China's East Asian neighbors have demonstrated.

## Notes

1. According to this official news agency, “Urban and rural per capita disposable income reached 33,616 yuan and 12,363 yuan in 2016, up 5.6 percent and 6.2 percent in real terms, respectively, according to the National Bureau of Statistics.” Based on these two numbers, we can calculate the urban-rural income ratio (See *Xinhua* 2017).
2. According to the 2013 data released from the China State Statistical Bureau, in 2012 China’s urban-rural income ratio reached its highest since 1978. In 2012, urban average income was 17,175 yuan, while it was 5,153 yuan in rural areas, and the urban-rural income ratio was 3.33:1, compared to 3.32:1 and 3.31:1 in 2007 and 2008, respectively. If we include the hidden benefits received by residents with formal urban hukou, this ratio could rise to 6:1. See <http://wenda.so.com/q/1363044987065138> (in Chinese; accessed June 21, 2017).
3. In 1958, the Chinese government officially promulgated the family register system to control the movement of people between urban and rural areas. Individuals were broadly categorized as a rural or urban worker. A worker seeking to move from the country to urban areas to take up nonagricultural work would have to apply through the relevant bureaucracies. The number of workers allowed to make such moves was tightly controlled. Migrant workers would require six passes to work in provinces other than their own. People who worked outside their authorized domain or geographical area would not qualify for grain rations, employer-provided housing, or health care.

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