China Faces Tough Choice on Growth

Incoming Leaders Must Decide Whether to Stick to Old Economic Model or Tackle Reforms to Get More Money to Consumers

By TOM ORLIK And BOB DAVIS

Reuters

Income inequality has pushed China's growth off kilter. A woman uses a pickax to obtain materials at a demolition site in Hefei in Anhui province.

BEIJING—China's latest evidence of sputtering growth underlines a dilemma for its incoming leaders: They can shore up the economy by doubling down on an exhausted growth model, or take a risky political bet on reforms that could worsen the slowdown in the short term.

The challenge—an unusual one for a Communist government—is to put more money in the pockets of its consumers by tackling the burgeoning inequality in income, which has contributed to pushing China's growth off kilter.

The 7.4% year-on-year rise in China's gross domestic product in the third quarter, reported Thursday, was the weakest growth rate since the start of 2009 and the seventh straight quarter of decline. Nevertheless, those hoping for a "soft landing" in China, ever-more important for the health of the global economy, took heart from some signs of stabilization. Industrial output, exports and investment all crept up in September. Employment has also stayed strong.

That raises the question for Beijing of whether to use its usual levers to pump up the economy, or to try to put China on a sustainable growth path by focusing more on spending by domestic households and less on investment and exports.

The traditional methods of kick-starting growth—cutting interest rates and boosting investment—would risk exacerbating economic imbalances, increasing investment returns at the expense of salaries and spending money for households.

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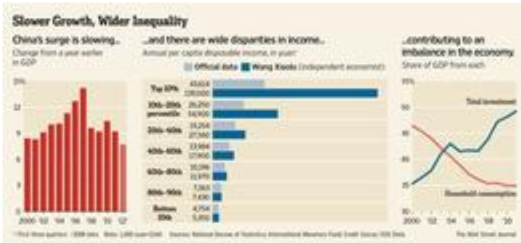

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Spreading the gains from China's growth means challenging some of the most powerful groups in the country's body politic: local officials who benefit when their governments flip land bought on the cheap from farmers, and state-owned enterprises whose low taxes translate into less money for welfare programs. The winners in such a gamble would be China's lower and middle-income households, which are increasingly looked to as the source of future growth.

Revamping the state-owned sector so the firms operate in a more commercial fashion could cost as many as four million jobs as the companies slim down and shed political tasks and subsidies, said Minxin Pei, a China expert at Claremont McKenna College. "It wouldn't be privatization; it would be departyization," Mr. Pei said.

Incomes have risen across China in the past decade, but political elites have benefited disproportionately from a system that massively enriches those closest to the center of power.

The problem is that what is good for the elites is no longer good for China: Deepening inequality now stands in the way of a long-stated goal of shifting China's growth model so that it depends more heavily on domestic consumption.

"To get really big [reform], you have to go for a redistribution of income," said International Monetary Fund chief economist Olivier Blanchard.

According to a new national survey of China's household income, China's richest 10% control 56.9% of household income and 84.6% of household wealth—"a level of inequality seen only in some struggling African nations," said Gan Li, a professor at Texas A&M University who led the survey.

The deepening inequality also makes it tougher to safeguard against the fate of other one-time economic stars that failed to advance to the ranks of wealthy nations.

Brazil's boom economy stagnated in 1980s and 1990s, for instance, as the country cleaved further into haves and have-nots, a pattern that some fear could be repeated in China. "There's a race in China between economic disparity and the rise of the middle class," says Cheng Li, a Brookings Institution senior fellow.

Bolstering low- and middle-income households is important economically because these people spend a higher share of their income than rich households. The savings rate for China's top 10% of urban households is 38%, compared with 27% for middle-income households and 8% for the bottom 10%.

Gao Jing, a 39-year-old migrant to Beijing, says she feels stuck. Ms. Gao runs a tiny store and earns about 2,500 to 3,000 yuan a month ($400 to $475), just enough to support her two children, she says. "Poor people like us find it hard to earn money, no matter how hard we work." Returning to her home province of Henan isn't an option, she says, because economic prospects are poor and the schools are bad.

Concern about inequality is becoming increasingly commonplace in China. According to a 2012 Pew Research Center poll of 3,177 Chinese, 48% say the gap between rich and poor is a very big problem, up from 41% in 2008.

Addressing inequality would require measures including protecting farmers' land rights to give them a valuable asset to sell or develop; granting migrant workers urban residency; and cracking down on corruption that enriches China's elites. All would require taking on powerful vested interests.

The current administration has long promised stronger land rights for China's farmers. Local political chiefs and real-estate firms, however, are both enriched by sales of land that local governments buy cheaply from farmers.

Farmers receive compensation of $17,850 per acre, on average, for land seized by local authorities, just 2.4% of the $740,000 per acre market value, according to a 2011 survey of 1,791 farmers conducted by Landesa Rural Development Institute.

China's 168 million migrant workers help build, clean and serve the cities, but few have the opportunity to make permanent homes there. That is because of the rigid urban-residency system that denies migrant workers and their families access to health care, education and welfare benefits in towns, whose governments see migrants as a source of cheap labor rather than members of the urban population.

Reducing income inequality would also require action to tamp down on corruption. A state-dominated economy, where officials control access to valuable assets, provides ample opportunities for graft.

Transparency International ranks China as the 75th most-corrupt country in the world, slightly above Colombia. A 2008 study by Wang Xiaolu of the China Reform Foundation found that China's richest 10% of urban households had average annual per capita disposable income of 139,000 yuan, three times higher than the official data suggest. The "gray income" that accounts for much of the difference often has its origins in the misuse of power and is closely connected with corruption, Mr. Wang wrote.

Some analysts criticized Mr. Wang's survey, saying it used an unrepresentative sample.

The Chinese Internet site Baidu has created an online forum devoted to the issue of income inequality. "The higher hope you have, the more disappointed you will get," read one recent posting. "The wealth gap is getting bigger, with the rich people buying fancy cars and houses while the poor people can't even afford the rent. That is the reality of China now."

President Hu Jintao and Premier Wen Jiabao, set to step down at the 18th Party Congress in November, promised a more "harmonious" society. But policies that juiced returns to investment and kept wages low also kept the income gap wide. The share of consumption in China's GDP fell to 34% in 2011, from 44% in 2002.

Consumption never fell to that low a level in the U.S, going back as far as the 19th century, or in the fast-growing Asian tigers during their growth years, according to McKinsey Global Institute. The share of household spending in GDP in the U.S. is about 70%.

The burden of reform will fall on the men expected to succeed them, Vice President Xi Jinping and Vice Premier Li Keqiang.

But don't expect China's new leaders to move quickly. Central bank chief Zhou Xiaochuan has privately told Western officials that it would take until the fall of 2013 to put together a reform package, said a former U.S. official. "To complete a smooth succession, Li and Xi probably have to keep their heads low," said Fred Hu, chairman of Primavera Capital, a Beijing private-equity firm.

The beneficiaries of change, lower- and middle-income households, have little voice in the policy process. But the costs of failure in slower growth and political instability could be high.

"Japan's growth slowed when the economy was already wealthy, and levels of inequality were very low. That provided a baseline of stability for their lost decade," said Scott Rozelle, an expert on China's economy at Stanford University. "If China's economy in the next 20 years follows the same trajectory as the last 10, they could face zero growth as one of the most unequal societies in the world."

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