
**From poor areas to poor people:
China's evolving poverty reduction agenda**
An assessment of poverty and inequality in China

March, 2009

Poverty Reduction and Economic Management Department
East Asia and Pacific Region
World Bank



CURRENCY EQUIVALENTS

(As of March 5, 2009)

Currency	=	Renminbi
Currency Unit	=	Yuan
US\$1.00	=	RMB 6.844

FISCAL YEAR

January 1 – December 31

WEIGHTS AND MEASURES

Metric System

ABC	Agricultural Bank of China	NBS	National Bureau of Statistics
ADB	Asian Development Bank	NCMS	National Cooperative Medical Scheme
BMI	Basic Medical Insurance	NDRC	National Development and Reform Commission
CASS	Chinese Academy of Social Services	NGO	Non-Government Organization
CASS-	Chinese Academy of Social Sciences	NPSS	National Population Sample Survey
IOS	Institute of Sociology		
CCT	Conditional Cash Transfer	PCE	Per Capita (living) Expenditure
CDPF	The China Disabled Persons' Federation	PMT	Proxy Means Testing
CDRF	China Development Research Foundation	PPP	Purchasing Power Parity
CHIP	China Household Income Project	PPS	Probability Proportionate to Size
CIDS	China Income Distribution Survey	PRC	Peoples Republic of China
CMS	Cooperative Medical Scheme	RCRL	Rural Land Contracting Law
COL	Cost of Living	RHS	Rural Household Survey
CPI	Consumer Price Index	SEAC	State Ethnic Affairs Commission
CULS	China Urban Labor Survey	SISBEN	Selection System of Beneficiaries for Social Program
DFID	Department for International Development	SOE	State-Owned Enterprises
FFW	Food for Work	SPA	Social Pool Account
GDP	Gross Domestic Product	SWOT	Strength, Weakness, Opportunity, Threat
HRS	Household Responsibility System	TVE	Township and Village Enterprise
ICP	International Comparisons Program	UDB	Urban Di Bao
ILO	International Labor Organisation	UHS	Urban Household Survey
IVDP	Integrated Village Development Program	UI	Unemployment Insurance
LGOPAD	Leading Group Office of Poverty Alleviation and Development	UMT	Unverified Means Testing
LML	Land Management Law	URBMI	Urban Resident Basic Medical Insurance
MA	Medical Assistance	USFHS	Urban Short-Form Household Survey
MOCA	Ministry of Civil Affairs	VLS	Village-Level Survey
MOA	Ministry of Agriculture	VMT	Verified Means Testing
MOLSS	Ministry of Labor and Social Security	WTO	World Trade Organisation
MSA	Medical Savings Account		

Vice President: James Adams
Country Director: David Dollar
Sector Director: Vikram Nehru
Task Team Leaders: Gaurav Datt and Shubham Chaudhuri

Table of contents

Preface and acknowledgements	i
Executive summary	iii
China's record of poverty reduction and growth is enviable	iii
But the task of poverty reduction continues and in some respects has become harder	iv
Policy initiatives in response to these challenges suggest a broader poverty reduction agenda is evolving	xi
What the review suggests about the main priorities for poverty reduction and what is needed to implement them	xiii
Adopting a broader conception of poverty and an adequate threshold for identifying and targeting the poor	xiii
Retaining rural poverty reduction as the top priority	xiii
Promoting opportunity by raising the returns to labor	xv
Enhancing security by expanding and improving the coverage of the social protection system in rural and urban areas	xix
Fostering equity and reducing poverty by ensuring secondary school education and basic healthcare for all	xxiv
Supplementing area-based poverty reduction efforts with a household-oriented approach.....	xxvii
Providing an adequate and equitable allocation of resources for local governments.....	xxviii
Strengthening institutional arrangements to promote participation, enhance accountability and improve coordination.....	xxx
Enhancing statistical monitoring and evaluation capacity.....	xxxii
PART I WHY REVIEW CHINA'S POVERTY REDUCTION AGENDA?	1
1. China's poverty reduction record over the last quarter century has been remarkable	3
a. The incidence, depth and severity of poverty have declined dramatically both according to official poverty estimates and by international standards	3
Between 1981 and 2004, the fraction of the population consuming less than a dollar-a-day fell from 65% to 10%	4
...and half a billion people were lifted out of poverty	6
The depth and severity of poverty also declined considerably	7
b. Between 2001 and 2004 the pace of poverty reduction accelerated	7
c. ...and there are indications that poverty has continued to decline up to 2007	10
d. But the progress in poverty reduction has been temporally uneven...	12
e. ...and, at the household level, income growth has been uneven	12
2. But the task of poverty reduction is not complete and in some respects has become harder	17
a. Measured by international standards, the number of poor in China remains high	17
China's official poverty line is low by international standards	18
China's official poverty line seems low relative to rising incomes and growing aspirations	19
China's poverty line may not cover essential food and non-food needs.....	22
b. Vulnerability to poverty because of income shocks remains widespread	23
Nearly a third of China's rural population was poor at least once between 2001 and 2004.....	24
A large part of the severity of poverty in rural China is attributable to risk.....	26
Exposure to risk may be one reason why China's poor have unusually high savings rates	29
c. Eliminating the remaining poverty has become harder as the poverty rate has declined	30
...because the remaining poor are harder to reach	30
...and because the responsiveness of poverty reduction to economic growth has fallen	31
d. Income inequality has increased significantly	33
China is no longer the low-inequality country it was a quarter century ago.....	33
The rural-urban income gap has grown.....	35
...and inequality within both rural and urban areas has risen.....	36
...while the contribution of inter-provincial income differences to overall inequality has narrowed	36
e. Disparities in other aspects of human development remain and in some cases have grown	37

Because of the marketization of public services, incomes now matter more for access to health and education than they used to	38
...and the burden of health and education expenditures has increased for households	38
f. Restructuring of the urban labor market and the dismantling of the iron rice bowl has led to new challenges	39
Unemployment has risen in urban areas while labor force participation has decreased	39
Growing informalization of the urban labor market has raised concerns about the welfare of urban workers	39
g. A large “floating” population of rural migrants has emerged in urban areas	40
The nature of migration is changing and integrating migrant workers and their families into urban areas poses new challenges	41
3. A poverty reduction agenda consistent with the vision of a xiaokang society	43
a. The challenges that remain as well as those that have emerged suggest a case for reviewing and broadening China’s poverty reduction agenda	43
b. Recent policy initiatives suggest that a broader poverty reduction agenda is indeed evolving	43
PART II REVIEWING CHINA’S POVERTY REDUCTION AGENDA	47
4. Establishing the basic facts about poverty and the poor in China	49
a. The poor in China are predominantly from rural areas	49
Virtually all of the China’s poor are in or from rural areas	49
The numbers of non-hukou migrants from rural areas have grown dramatically	50
Excluding migrant workers from the rural population, 90% of poverty is still rural	51
Only with a 50% or higher urban-rural cost of living differential is there any noticeable poverty amongst urban residents	52
b. Geography and ethnicity matter but are not the only determinants of poverty	54
The incidence and severity of poverty is highest in the western region but nearly half of the poor are elsewhere	54
Poverty is most severe in mountainous and minority areas, but more than half the poor are in non-mountainous non-minority areas	55
c. The poor are dispersed throughout China’s villages	57
Measuring the extent to which poverty is concentrated within villages	57
The concentration of poverty within villages is highest in the southwestern region and least in the coastal region	58
The concentration of poverty tends to decline as the incidence of poverty itself declines	59
d. Most of China’s poor are able to work	59
Nearly three-quarters of China’s rural poor live in households where no-one lacks work capacity and 97% live in households with two or more productive members	60
What the poor lack is human capital	61
e. More than the elderly, children, and in particular, girls, are likely to be poor	62
f. The poor have some characteristics in common, but differ in other ways	64
Constructing a taxonomy of the rural poor in China	64
The rural poor can be usefully grouped into seven clusters, each distinguished by a particular disadvantage	66
The regional distribution of the clusters varies, as does the importance of individual clusters within each region	66
g. A profile of the disadvantaged in urban areas	69
There is no single threshold for identifying the urban “poor”	69
Nearly 20 million people in urban areas consume less than twice the World Bank poverty line and may be considered the “urban disadvantaged”	71
The urban disadvantaged are relatively evenly spread across regions but heavily concentrated in smaller cities	72
The elderly in urban areas are no more likely to be disadvantaged than other age groups	73
Households without high-school educated workers constitute most of the disadvantaged in urban areas	74
Ethnic minorities and those without local urban hukou are more likely to be disadvantaged but are relatively few in number	74
More than half of the urban disadvantaged live in households with unemployed workers	75

5. Promoting opportunity: helping the poor move out of poverty	78
a. China's poverty reduction efforts have been development-oriented	78
Rural Reforms and the introduction of the Household Responsibility System were central to poverty reduction during the early 1980s	78
Area-based efforts began with the National Poverty Reduction and Development Programs during 1986-1993	79
The 8-7 Poverty Reduction Plan continued and intensified these efforts during 1994-2000	79
Further refinements were made in the New Century Poverty Reduction Strategy for 2001-2010.....	80
The funding for poverty alleviation programs comes from multiple sources.....	81
b. Raising Incomes through poor-area development: the Integrated Village Development Program	82
A reasonably good effort was made to designate poor villages according to specified criteria.....	82
But more than half the poor live outside the designated villages.....	83
The program raised incomes in designated villages but the poorest households have failed to benefit.....	87
Program impacts hampered by difficulties in inter-agency coordination, inadequate resources and limited participation of poor households	89
c. Raising Incomes through other developmental poverty reduction programs: training for labor transfer, subsidized credit and agribusiness	91
Training for labor transfer.....	91
Subsidized credit and agribusiness	92
d. How can developmental poverty reduction programs better help the poor?	93
e. Rural-to-urban migration as a path out of poverty	95
Large and growing scale of migration though full-family migration remains limited	95
Most migration is inter-provincial, from central and southwest to coastal areas, and to medium and large cities	97
Male young adults with junior high school education are more likely to migrate	101
Migration reduces poverty.....	102
But many of the poor are unable to migrate.....	103
There remain several impediments to migration.....	106
What do potential migrants say?.....	108
The downside of migration in source areas	108
Policy implications.....	110
6. Enhancing security: protecting households from falling into poverty	112
a. Land allocations alone are an inadequate basis for the rural safety net	112
There are large variations in the productivity of land	113
The share of farm income in rural income continues to decline	114
Despite recent improvements, security of tenure is still limited by land readjustments and requisitions...	114
b. Are rural social protection programs adequate?	117
Features of key social assistance programs in rural areas.....	118
Coverage of rural social assistance programs has expanded but remains uneven relative to the levels of poverty.....	121
Benefit levels for recipients are low for several programs especially in comparison with similar urban programs	122
Benefit levels and coverage vary from areas to area, not with need, but with local fiscal resources	123
Coverage of rural health insurance has improved dramatically but challenges of limited coverage of rural pensions and low benefit levels of all programs remain	125
Policy implications.....	128
c. Promoting re-employment in a changing urban labor market	129
Nearly half of all urban employment is informal in nature	130
High unemployment and declining labor force participation	132
Urban poverty is linked to the work status of household members	134
Promoting re-employment in urban areas.....	135
Policy implications.....	136
d. Replacing the iron rice bowl: urban social insurance programs	136
Features of the main urban social insurance programs.....	136
Policy issues	140
e. Replacing the iron rice bowl: the urban Di Bao program	143
Key features of the program	144
Characteristics of urban Di Bao beneficiaries resemble those of the relatively poor in urban areas.....	145
Assessing Di Bao's performance	148

By international standards, urban Di Bao has excellent targeting performance	149
But the coverage of the program could be increased	151
Eligibility thresholds vary with local fiscal resources rather than with need.....	152
At least in terms of its design, if not in practice, work disincentive effects of the program are a concern .	153
Policy issues	155

7. Fostering equity: reducing disparities and building human capacities..... 159

a. The rise in income inequality is a concern but it is important to be clear on the reasons why	159
b. Inequalities in human capital underlie the three components of income inequality that have risen the most	160
Differences in the human capital endowments of rural and urban workers explain much of the rural-urban labor productivity gap	160
Differential access to off-farm employment due, increasingly, to differences in schooling is the most visible source of inequality within rural areas.....	162
Income inequality within urban areas stems primarily from disparities in labor incomes attributable in large part to differences in educational attainment	163
c. Disparities in other aspects of human development mirror, and can be traced to disparities in income, raising the possibility of an inequality trap	167
Changes in institutional arrangements have led to a marketization of public service delivery, particularly in rural areas	167
Incomes matter more now than they used to for access to health and education.....	167
...and the burden of health and education expenditures has increased for households.....	168
Because health and education determine income prospects, this raises the possibility of an inequality trap	168
d. Compulsory education finance reform has helped improve access to affordable basic education but many challenges remain	169
e. Publicly-financed interventions can ensure equity of opportunity but under China's current fiscal system do not adequately do so	171
Expenditures on poverty-reduction-related activities are primarily the responsibility of local governments	171
Despite recent initiatives to enhance equalizing transfers, public expenditures tend to favor richer provinces and localities	173
Disparities in spending can be even more pronounced at lower levels of government.....	174
f. Group-based inequities are particularly visible along certain axes	175
The rural-urban income gap is only one manifestation of the great divide that separates China's urban and rural areas	175
The gender gap in China begins at birth and continues through the working years and into old age.....	176
Integrating rural migrant workers and their families in urban areas.....	178

PART III WHAT THE REVIEW SUGGESTS ABOUT THE POVERTY REDUCTION AGENDA..... 187

8. What the priorities are and what is needed to implement them..... 189

a. Adopting a broader conception of poverty and an adequate threshold for identifying and targeting the poor	189
b. Retaining rural poverty reduction as the top priority	190
c. Promoting opportunity by raising the returns to labor	191
Realizing the potential of migration for poverty reduction	191
Promoting agricultural and rural development in poor areas	193
d. Enhancing security by expanding and improving the coverage of the social protection system in rural and urban areas	195
Improving rural social protection	195
Improving urban social protection	197
Harmonizing the rural and urban systems	199
e. Fostering equity and reducing poverty by ensuring secondary school education and basic healthcare for all	199
Improving access to affordable education	200
Improving access to affordable healthcare	201
f. Supplementing area-based poverty reduction efforts with a household-oriented approach	202

g. Providing an adequate and equitable allocation of resources for local governments	203
h. Strengthening institutional arrangements to promote participation, enhance accountability and improve coordination	205
i. Enhancing statistical monitoring and evaluation capacity	206
Data appendix.....	208
Rural and Urban Household Surveys (NBS)	208
2004 World Bank-NBS Special Purpose Village-Level Survey	209
China Urban Labor Survey (CULS)	210
2006 Qualitative Study of Poverty	210
Data and information from secondary sources	211
References.....	212

Preface and acknowledgements

This report brings together findings from a multi-year analytical activity undertaken by the World Bank on a policy-oriented assessment of poverty in the People's Republic of China.

The report was prepared by a poverty assessment team led by Gaurav Datt and Shubham Chaudhuri from the East Asia Poverty Reduction and Economic Management Department of the World Bank. The other members of the core team who contributed to the analytical work undertaken for the report and its drafting included Albert Park (Oxford University), Sangui Wang (School of Agricultural and Rural Development, Renmin University), Yaohui Zhao (China Center for Economic Research, Peking University), and Fang Cai (Institute of Population and Labor Economics, Chinese Academy of Social Sciences). The larger team also included Tao Kong (Australian National University), Dewen Wang and Du Yang (Institute of Population and Labor Economics, Chinese Academy of Social Sciences), Liu Xuejun (Beijing Normal University).

The poverty assessment study was conducted and completed by the World Bank, and reflects the Bank's latest analysis, judgments and views on poverty and inequality issues in China. The State Council's Leading Group Office of Poverty Alleviation and Development (LGOPAD) provided a great deal of support in the process of the study and the revisions of the report, as well as coordinated the process of seeking comments from other Chinese agencies and experts involved in the poverty reduction program. In particular, we are grateful to Zhang Lei, Wu Zhong, Huang Chengwei, Tian Weiping and Cao Hongmin for their positive contribution throughout the process of the poverty assessment study.

The primary counterparts on the technical side were the Rural and Urban Household Survey Organizations of the National Bureau of Statistics with whom collaborative work arrangements were established that enabled detailed analyses of data from their rural and urban household surveys. The poverty assessment team is grateful to the NBS for not only giving access to the household survey data, but also for providing technical advice and feedback at different stages of the work, and actually participating in the analytical work in the course of four data analysis workshops organized by the poverty assessment team during 2004-6 in Washington DC, Beijing and Sydney. In particular, we would like to acknowledge our gratitude to Sheng Laiyun, Yang Junxiong, Yan Fang, Chen Xiaolong and Wang Youjuan for their generous support.

We are also grateful to the Rural Survey Organization of NBS for conducting the 2004 NBS-World Bank Special Purpose Village-Level Survey covering 3037 villages throughout China for the purposes of this poverty assessment.

We are also grateful to the Institute of Population and Labor Economics, CASS, for organizing and conducting the China Urban Labor Survey in 5 large and 5 small cities in 2005 for this poverty assessment, and to the Institute of Sociology, CASS, for conducting a qualitative study of poverty in 12 villages across six provinces in China. Our thanks also go to John Taylor for coordinating this qualitative study.

On November 3, 2005, a draft of the report was released at a workshop jointly hosted by the World Bank and LGOPAD. Suggestions of various participants at the workshop were very helpful in the preparation of this report.

On February 27, 2008, a group of Chinese experts were invited by the World Bank and LGOPAD for a discussion of the draft of the report. The twelve Chinese experts gave a thorough evaluation of the report and put forth many useful suggestions for revising the report.

From September to November 2008, with the support of LGOPAD, we also asked for suggestions from the National Reform and Development Commission, the Ministry of Agriculture, the Ministry of Human Resources and Social Security, the Ministry of Civil Affairs, the Ministry of Health, the Ministry of Education, the National Bureau of Statistics

and other government counterparts, and received a lot of positive feedback. This has played a significant role in improving the report.

The support from DFID for this work from the Trust Fund under the World Bank-DFID China AAA Partnership is gratefully acknowledged. Interaction and exchange of ideas with Christopher Athayde, Arjan De Haan, Rahul Malhotra, and Jillian Popkins from DFID was also very helpful in the development of the work for this report.

The report benefited from the comments of peer reviewers Emmanuel Jimenez (Sector Director, EASHD), Ravi Kanbur (Cornell University), Justin Yifu Lin (Chief Economist, World Bank), Shahid Yusuf (Economic Adviser, DECRG), and Christine Wong (University of Washington).

The report was prepared under the overall guidance of Vikram Nehru (Sector Director, EASPR). Strategic guidance was also provided by David Dollar (Country Director, China), and Bert Hofman (Country Director, Philippines, and ex-Lead Economist for China, EASPR). The report also benefited from the guidance of Homi Kharas and Indermit Gill during their tenures as Sector Director and Sector Manager at EASPR. We are also grateful to Ardo Hansson (Lead Economist for China, EASPR) for support and guidance during the final preparation and review of the report.

Jianqing Chen and Zijing Niu provided invaluable project management throughout this activity for which we are extremely grateful. Louisa Huang helped us with the management of the DFID Trust Fund.

A number of people helped in the preparation of this report by providing useful feedback, comments and various other forms of input at different stages of the work undertaken for the report. From within the World Bank, we are grateful for this support to Deepak Bhattasali, Shaohua Chen, Klaus Deininger, Achim Fock, John Giles, Li Guo, Louis Kuijs, Magnus Lindelow, Xiaofan Liu, Philip O'Keefe, Alan Piazza, Martin Ravallion, Adam Wagstaff, Kin Bing Wu, and Xiaoqing Yu. Amongst those from outside the World Bank, we are thankful to Sara Cook, Jikun Huang, Scott Roselle, and Pinping Wang.

Executive summary

China's record of poverty reduction and growth is enviable

China's record over the last quarter century in reducing extreme poverty has been remarkable

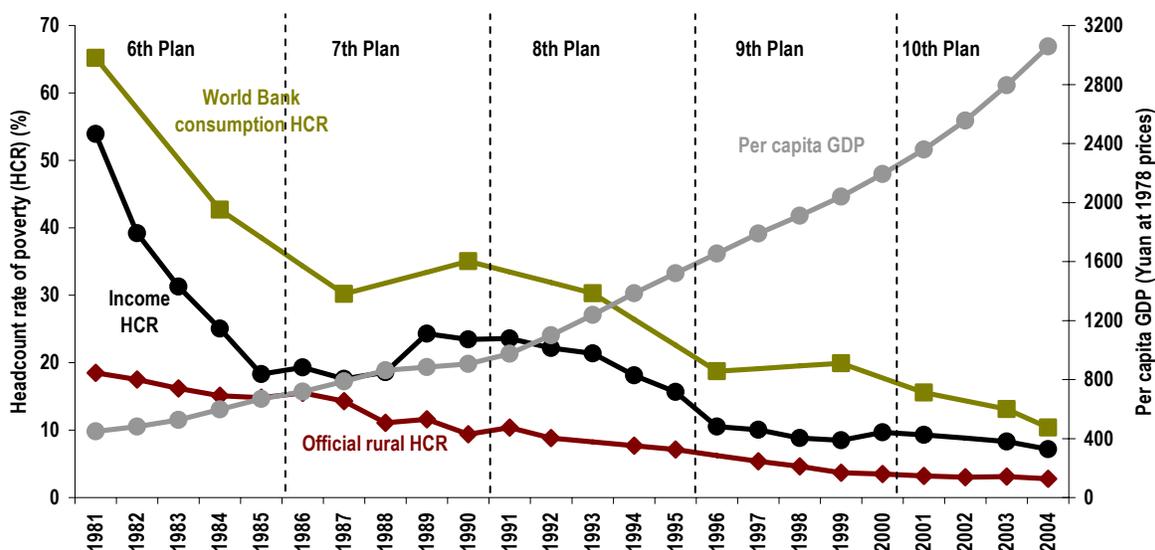
China's progress in poverty reduction over the last 25 years is enviable. One cannot fail to be impressed by what this vast nation of 1.3 billion people has achieved in so little time. In terms of a wide range of indicators, the progress has been remarkable. Poverty in terms of Income and consumption has been dramatically reduced. Progress has also been substantial in terms of human development indicators. Most of the Millennium Development Goals have either already been achieved or the country is well on the way to achieving them. As a result of this progress, the country is now at a very different stage of development than it was at the dawn of the economic reforms at the beginning of the 1980s.

Between 1981 and 2004, the fraction of the population consuming less than a dollar-a-day fell from 65% to 10%, and more than half a billion people were lifted out of poverty

By China's official poverty standard, the poverty rate (headcount ratio) in rural China fell from 18.5% in 1981 to 2.8% in 2004 and the number of rural poor declined from 152 million to 26 million. Measured in terms of the World Bank poverty standard of (of 888 yuan per person per year at 2003 rural prices), China's poverty reduction performance has been even more striking. Between 1981 and 2004, the fraction of the population consuming below this poverty line fell from 65% to 10%, and the absolute number of poor fell from 652 million to 135 million, a decline of over half a billion people (Figure 0.1). A fall in the number of poor of this magnitude over such a short period is without historical precedent. To put this in perspective, the absolute number of poor in the developing world as a whole declined from 1.5 to 1.0 billion over the same period (World Bank, 2007); in other words, but for China there would have been no decline in the numbers of poor in the developing world over the last two decades of the 20th century.

Measured by the new international poverty standard of \$1.25 per person per day (using 2005 Purchasing Power Parity for China), the levels of poverty are higher, but the decline since 1981 is no less impressive (from 85% in 1981 to 27% in 2004).

Figure 0.1 : China's record of poverty reduction and growth over the last quarter century has been remarkable



Sources and notes: See main report.

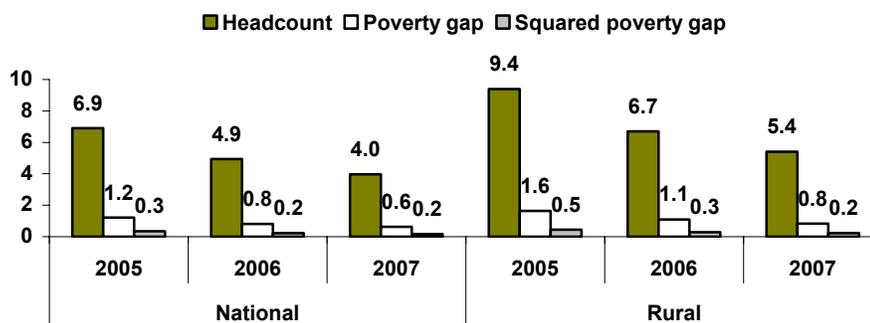
Between 2001 and 2004 the pace of poverty reduction accelerated,

The decline in the incidence of poverty was, however, uneven over the two and a half decades since 1981. Five broad phases can be distinguished, broadly coinciding with the

and there are indications that poverty has continued to decline rapidly up to 2007

five Five-year Plan periods. The most rapid declines in poverty, in both the poverty rate and the number of poor, occurred during the 6th, 8th, and 10th Plans. During the 7th Plan period the number of poor actually rose, while in the 9th Plan period, the poverty rate declined only marginally. But the pace of poverty reduction resumed between 2001 and 2004 and there are indications that during the first couple of years of the 11th Plan poverty has continued to decline rapidly. The percentage of China's population consuming less than the World Bank poverty line is estimated to have fallen from 10.3% in 2004 to 4.0% in 2007 (Figure 0.2).

Figure 0.2 : Progress in poverty reduction during 2005-2007 (World Bank poverty line: 888 yuan per person per year at 2003 rural prices)



Source and notes: See main report.

Growth has been central to China's poverty reduction performance...

The rapid growth that has resulted from the series of economic reforms that China adopted as it transitioned from a planned to a market-oriented economy has been central to China's poverty reduction performance. During the period 1981-2005 as a whole, real per capita GDP grew at the trend rate of 8.3% per year, while the headcount index of poverty fell at the rate of 7.1% per year. Thus, every 10% increase in per capita GDP was associated with a 9% fall in the incidence of poverty. Key reforms have included the introduction of the Household Responsibility System in agriculture in the early 1980s, creation of a conducive environment for the rise of Township and Village Enterprises in rural areas, which up to the mid-1990s grew rapidly to absorb a large share of the rural labor force, restructuring of the state industrial sector in the late 1990s, the opening up of the economy to global trade and investment and the resultant rapid growth of the urban economy which has been absorbing an ever-growing mass of migrant workers from rural areas. Policies that have directly supported rural incomes, such as the increase in agricultural procurement prices between 1993 and 1995, the elimination of agricultural taxes and fees between 2003 and 2006, the developmental poverty reduction programs and the recent expansion of social assistance have been important as well.

But the task of poverty reduction continues and in some respects has become harder

Extreme poverty, in the sense of not being able to meet the most elementary food and clothing needs, has almost been eliminated in China

The most recent official estimate of rural poverty in China for 2007 puts the number of poor at 14.79 million, or less than 2% of the rural population (NBS, 2008). While there is no official urban poverty line, estimates by others have found poverty levels in urban areas to be negligible using an urban poverty line that is comparable to the official poverty line for rural areas. These estimates thus suggest that only about 1% of China's population is currently in extreme poverty. In other words, extreme poverty, in the sense of not being able to meet the most elementary food and clothing needs, has almost been eliminated in China.

But the task of poverty reduction continues and in some respects has become harder

Notwithstanding this tremendous success, the central thesis of this report is that the task of poverty reduction in many ways continues and in some respects has become more demanding. China's successes have bred their own challenges. The many factors—policies as well as processes—that have contributed to the past success have also brought about structural changes, profoundly transforming the country's economic and

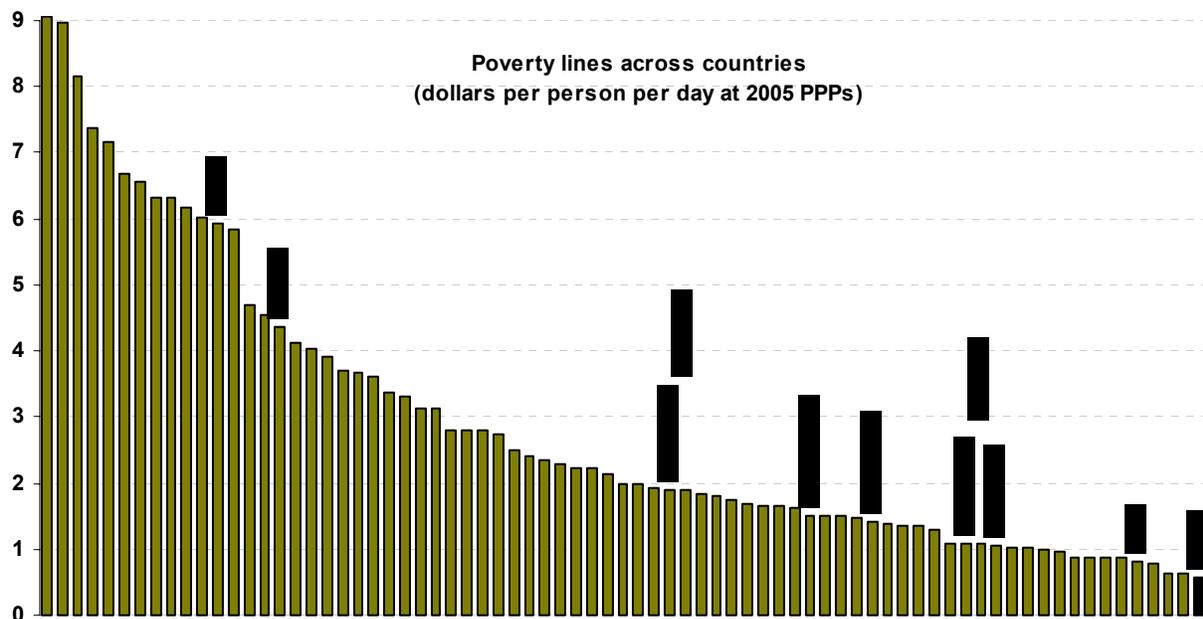
social landscape, and in the process have produced new challenges.

Thus, the task of poverty reduction continues and in some respects has become harder because:

Measured by international standards, the number of poor in China remains high

- Measured by international standards for identifying and counting the poor, the number of poor in China remains high. Because of the sheer size of China's population, using an international poverty standard, China still has the second largest number of consumption poor in the world after India. As of 2005, the latest year for which direct survey-based estimates are available, China still had 254 million people consuming less than \$1.25 per day in 2005 PPP dollars. If this assessment of the number of remaining poor in China appears to be at odds with the official estimates of only 15 million rural poor, it is because the official poverty line (set at 785 Yuan per person per year for 2007, or \$0.57 per person per day in 2005 PPP dollars) is particularly stringent, and is the lowest amongst a sample of 75 countries (Figure 0.3). The official poverty line seems low not only compared to international standards, but also relative to the rapid rise in mean incomes and growing aspirations within China. Furthermore, recent calculations suggest that even by the objective standard that a poverty line aims to capture—the minimum expense necessary for subsistence and to meet basic living needs—the official poverty line may be too low to adequately cover basic food and nonfood needs.

Figure 0.3 : China's poverty line in comparison with other countries



Sources and notes: See main report.

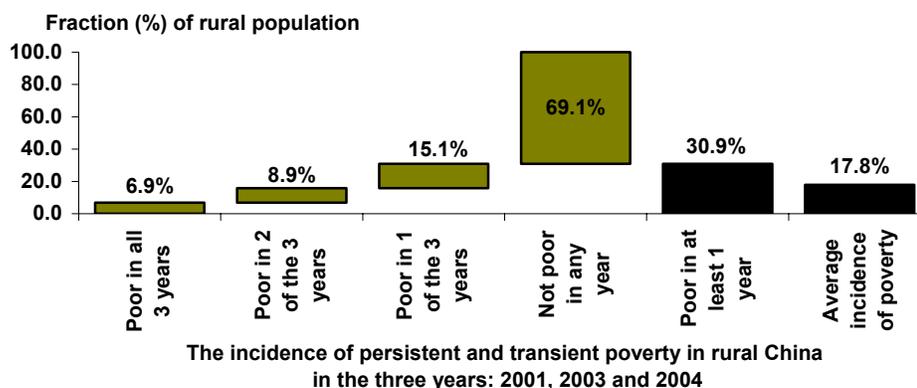
Vulnerability to poverty is widespread, especially in rural China, and number of those vulnerable to the risk of falling into poverty is about twice as high as the number of poor in a given year

- Vulnerability to poverty because of a variety of income shocks remains widespread. For instance, using the World Bank poverty line, nearly a third of China's rural population was consumption poor at least once between 2001 and 2004, about twice the number who were poor in any one year (Figure 0.4). Nearly 70% of the severity of income poverty and 40% of the severity of consumption poverty in rural China is attributable to risk. Even for those persistently poor, exposure to risk adds to the severity of their poverty. And the exposure to risk and the resulting need for precautionary saving may be one reason why, in 2003, 43% of rural households with per-capita annual incomes below the poverty line were saving, and amongst households with per capita incomes between the poverty line and twice the poverty line, the median savings rate was 17.5%. If domestic consumption is to supplement

investment and external trade as a central driver of China's economic growth, it will be important to reduce vulnerability to poverty.

Figure 0.4 : Almost a third of China's rural population was consumption poor in at least one year between 2001 and 2004

(% of the rural population that was dollar-a-day consumption poor in one or more years)

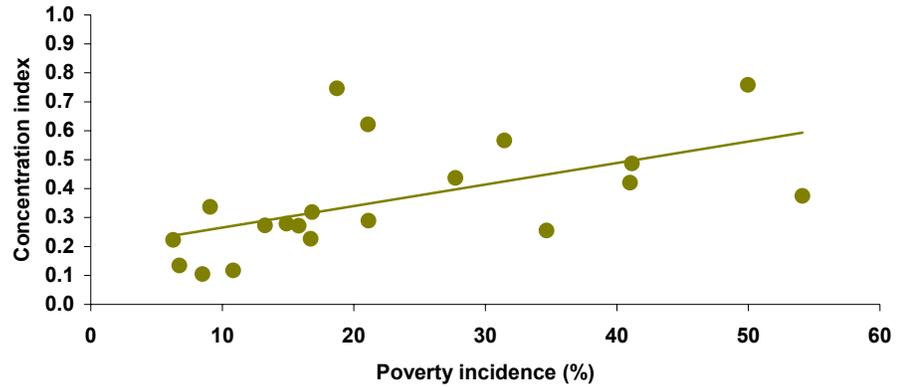


Source and notes: See main report.

As poverty rates have fallen, the remaining poor are harder to reach as they are more dispersed

- Across regions and topographic/ethnicity categories, the relative contribution of risk rises as poverty becomes less severe, which suggests that as China makes further progress in poverty reduction, the poverty challenge facing the country will increasingly take the form of tackling transient poverty. A relatively high share of transient poverty however does not mean that the problem of poverty has been rendered necessarily less serious or its solutions relatively easier. But, it does imply that social policies may have to focus on risk mitigation and risk management strategies more than was necessary when chronic poverty was the dominant form of poverty.
- Similarly, as the poverty rate has fallen, it has become harder to eliminate the remaining poverty because the remaining poor are more dispersed. While the incidence and severity of poverty is the highest in western provinces, nearly half the poor are dispersed in the rest of China, and likewise, while poverty is the most severe in mountainous and minority areas, more than half the poor are in non-mountainous non-minority areas. And as poverty levels are reduced, the village-level concentration of poverty tends to decline (Figure 0.5). This carries the important implication that as China makes further progress in alleviating poverty, the remaining poverty could be expected to be more dispersed thus eroding some of the potential benefits from area-based targeting relative to household-based targeting approaches.

Figure 0.5 : Poverty concentration declines at lower levels of poverty across region-topography-ethnicity categories in rural China, 2003



Sources and notes: See main report.

While economic growth has been critical for poverty reduction, the responsiveness of poverty to economic growth has decreased

- Economic growth has been critical for poverty reduction. The only period in the last quarter century when there was an increase in the poverty rate, albeit a relatively small one, was during the 7th Five Year Plan, between 1986 and 1990 when the growth rate fell to less than 4%. However, the task of poverty reduction has become harder because the poverty is now less responsive to economic growth. Whereas during the 6th Five Year Plan each percentage point of growth in real per capita GDP was associated with more than 2% reduction in poverty headcount rate, during the 10th Five Year Plan, the elasticity of poverty reduction with respect to growth had declined to about 1.

Table 0.1 : Responsiveness of poverty to growth has declined, 1981-2005

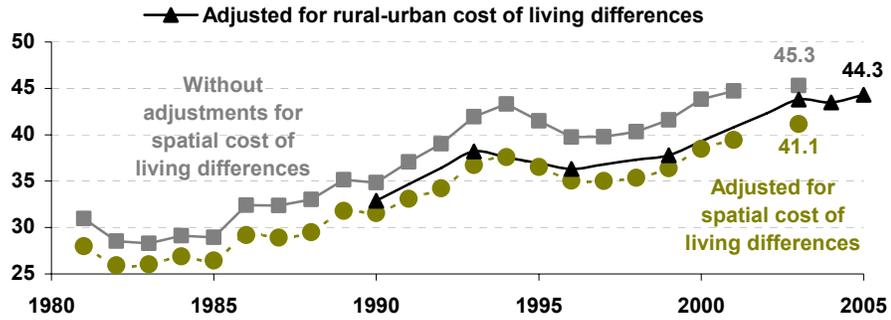
		Annual percentage change in:			Elasticity of headcount index with respect to real per capita GDP:	
		Per capita GDP			Un-conditional	Controlling for inequality
		Headcount index	(constant prices)	Gini index		
6th Plan	1981-1985	-26.1	10.2	-0.8	-2.52	-2.40
7th Plan	1986-1990	7.1	5.8	2.5	0.95	-0.43
8th Plan	1990-1995	-10.2	11.2	2.9	-0.90	-1.36
9th Plan	1996-2000	-3.4	7.0	2.3	-0.48	-1.54
10th Plan	2001-2005	-9.0	8.9	1.4	-1.03	-1.55
	1981-2005	-7.1	8.3	2.0	-0.87	-1.79

Sources and notes: See main report.

Income inequality has risen significantly because of a widening rural-urban gap and increasing inequality within both rural and urban areas

- Not everyone has participated in the economic success equally. Income inequality in China has increased significantly since the start of economic reforms, and China is no longer the low-inequality country it was a quarter century ago. The (unadjusted) Gini index of income inequality rose from 30.9% in 1981 to 45.3% in 2003 (Figure 0.6). Even adjusting for rural-urban cost of living differentials, the Gini index increased from 32.9% in 1990 to 44.3% in 2005, a level comparable to that in many other middle-income economies, including some in the East Asia region such as Thailand and Malaysia, though lower than that in many Latin American countries. Where China stands out is in the magnitude of the increase in inequality and the pace at which it has occurred. The rise in inequality is the result of both a widening income gap between the cities and the countryside, as well as growing inequality within rural and urban areas.

Figure 0.6 : The evolution of income inequality in China since the start of reforms (Gini index of income inequality from 1981 to 2005)



Source and notes: See main report.

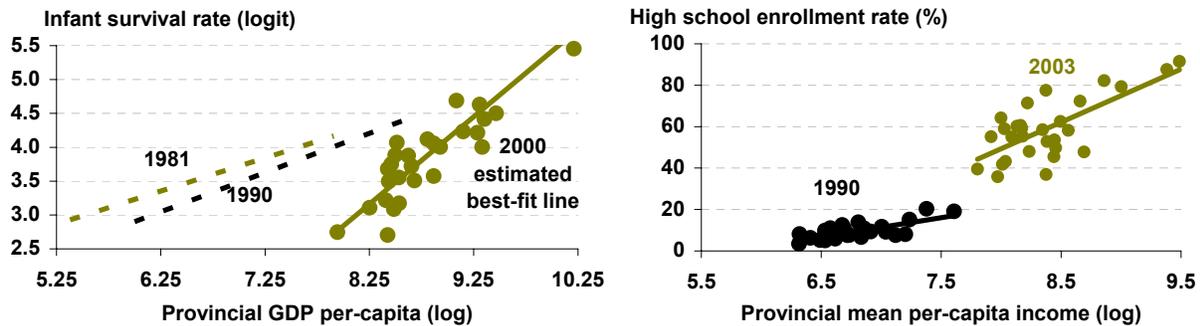
Disparities in other aspects of human development persist and mirror the disparities in income...

- China's successes have not only been in raising incomes. China's progress in human development has been equally, if not more, impressive. In terms of various human development indicators, China compares favorably to levels achieved in middle-income countries. But as in the case of income growth and poverty reduction, the progress has been uneven, and disparities in many non-income aspects of human development have grown in recent years across rural and urban areas, provinces and households.

... because incomes matter more now than they used to for access and outcomes in health and education, and the burden of health and education expenditures for the poor has increased

- That disparities in human development mirror disparities in income is largely due to the fact that incomes matter more now than they used to in determining access and outcomes in health and education, especially in rural areas (Figure 0.7). Incomes matter more now than they used to because the change in the institutional arrangements for the provision of health and education led to the marketization and monetization of service delivery. The dismantling of the communes in rural areas and the move to the Household Responsibility System was arguably the single most important reason for the rapid decline in poverty China experienced in the first half of the 1980s. However, a byproduct of this institutional transformation was the increasing monetization and marketization of public service delivery in rural areas. In place of the communes, local governments were charged with administering and financing these services, which in poorer areas, they were unable to fully do because of a lack of fiscal resources. Schools and health facilities have therefore had to increasingly rely on charging user fees in order to cover their costs.

Figure 0.7 : Health and education outcomes at the provincial level are more closely tied to incomes than they used to be



Sources and notes: See main report.

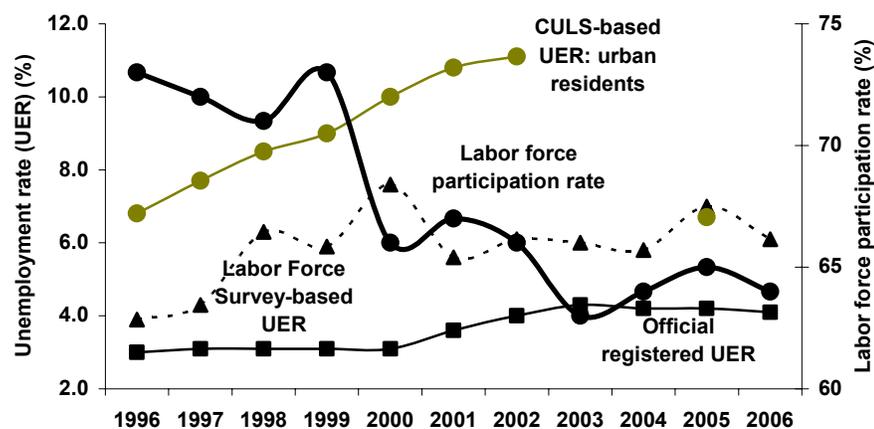
- A direct consequence of this is that the burden of health and education expenditures has increased for rural households. For instance, it is estimated that the share of educational expenditure in the household budget increased from 1.0 to 8.3 percent between 1988 and 2003, while the budget share of health expenditures increased

from 1.6 to 5.1 percent over the same period. Increases in the education and health budget shares for the bottom deciles were especially burdensome.

With large-scale restructuring of state-owned enterprises, unemployment has risen and labor force participation has declined in urban areas

- Beginning in the mid-1990s, China undertook aggressive restructuring of loss-making state-owned enterprises, leading to the layoffs of tens of millions of urban workers. Between 1994, when it was at its peak, and 2006, employment in state-owned enterprises and urban collectives fell by 73 million, from 145 million workers to 72 million. The restructuring of the urban labor market and the dismantling of the iron rice bowl led to rising unemployment and declining labor force participation rates (Figure 0.8). Unemployment rates have fallen from their peak around five years ago, but are still higher than they were in mid-1990s. The urban labor force participation rate fell by 10 percentage points between 1999 and 2003 and remains much lower than in the mid-1990s. Because the decline was associated with restructuring, there has been concern that many of those leaving the labor force are discouraged workers who do not get counted among the ranks of officially unemployed. Relative poverty in urban areas is increasingly associated with the work status of household members.

Figure 0.8 : Estimates of urban unemployment rates and labor force participation rate (%)



Sources and notes: See main report.

Growing informalization of the urban labor market raises concerns about the welfare of workers

- A corollary of the downsizing of the state sector in urban areas has been the diversification of the urban labor market, with non-state entities accounting for a growing share of urban employment since the mid-1990s. The fastest growing segment has been the category of “other” unregistered workers—unreported workers in registered enterprises, workers in unregistered informal enterprises and undocumented rural migrants in urban areas. The large increase in the number of such workers suggests that informal urban employment has increased significantly in recent years, and may account for nearly half of all urban employment (Table 0.2). The growing informalization (and diversification away from the state sector) of the urban labor market, while it has undoubtedly helped create jobs and facilitated the allocation of labor according to market principles, has also exposed urban workers to new forms of insecurity because informal employment is usually not contract-based and by its nature is “hidden”. That makes it harder to enforce protective regulations that ensure safe working environments and fair treatment of workers. It also poses a real challenge for developing and adequately financing sustainable social insurance systems that can offer adequate protection to the urban population.

Table 0.2 : Share of informal employment for local residents in urban China in 2002

	Share of informal employment (%)		Share of informal employment (%)		Share of informal employment (%)
All	45.3	By age:		By education level:	
By sector:		16-24	57.2	Primary and below	78.4
State and collective	22.9	25-34	44.6	Middle school	62.6
Other sectors	56.3	35-44	42.2	High school	48.6
By sex:		45-54	42.2	Junior technical school	35.9
Male	42.2	55-64	55.6	Specialized college	24.6
Female	49.5	>65	83.9	College and above	14.8

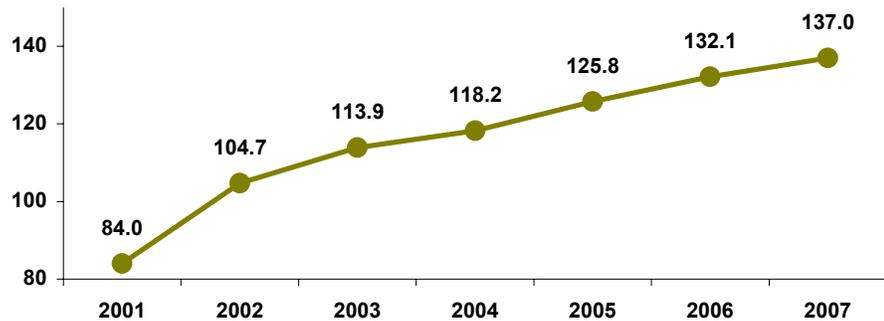
Source and notes: See main report.

The emergence of a “floating population” poses continuing challenges for social policy

- As an integral part of its growth process, China has witnessed internal migration from rural to urban areas on an unprecedented scale during the last decade a half, with the numbers of migrants continuing to grow in recent years (Figure 0.9). Described as the largest peacetime movement of people in history, large numbers of rural workers have migrated to the cities to work, pulled by the jobs in China’s fast-growing manufacturing and service industries, and pushed by the growing pool of surplus labor resulting from reforms in the agricultural sector. The result has been the emergence of a large (and still growing) “floating population”—estimated to be as many as 150 million people—who live and earn their livelihoods for increasingly longer periods each year in locations where, lacking a local (urban) resident status, they often have limited and highly variable access to basic social services, potentially suffer discrimination in access to economic opportunities, and are often treated as no better than “guest workers”. This has raised concerns about the emergence of an urban underclass whose coverage under the existing social protection programs and policies remains a continuing challenge.

Figure 0.9 : Rising tide of rural migrants, 2001-2007

(Number of rural migrants, million)



Sources and notes: See main report.

New systems of social protection are still evolving and many challenges remain

- The dismantling of the collective commune system in rural areas and the large-scale economic restructuring of the state and collective sector in urban areas completely overturned the foundations of the earlier social welfare and social security system. While China is well on its way to establishing new systems of social protection in urban and rural areas, this is still work-in-progress and many challenges remain.

Policy initiatives in response to these challenges suggest a broader poverty reduction agenda is evolving

These developments and challenges suggest that the task of poverty reduction needs to be viewed in broader terms. Partly as a result of China's economic success, and partly as a result of wide-ranging economic reforms that have profoundly transformed the structure of the economy, the nature of the (poverty) problem to be tackled has changed in important ways. The changing nature of the problem suggests that the task can not be limited just to the established focus on poor-area development, but that there is a case for broadening the agenda not just in terms of the spatial coverage of poverty reduction efforts, but also in terms of the basic objectives of such efforts, and the range of instruments and approaches adopted:

- First, the notion of income and consumption poverty itself may need to be broadened beyond the austere threshold of meeting "survival" needs of food and clothing to one that meets a more generous set of basic needs and capabilities for the country's population.
- Second, policy and structural changes as well as the important contribution of risk to current poverty point to a large social protection agenda in both rural and urban areas.
- Third, the experience with marketization of public services that eroded the near-universal access to basic health and education in the pre-reform period indicates the need for renewed focus on re-attaining this goal as part of the overall poverty reduction agenda.
- Fourth, the challenge of making the process of growth more pro-poor suggests the need to focus on ways of increasing opportunities for the poor to participate more fully in the growth process not just by increasing agricultural incomes but also through off-farm employment and realizing the potential of migration for poverty reduction.
- Fifth, greater dispersion of the poor suggests there may be a case for rebalancing the focus of poverty reduction efforts from poor areas to poor people.
- Sixth, the rapid increase in inequalities between as well as within rural and urban areas suggests that the task of fostering equity can not be delinked from the overall poverty reduction agenda.

A poverty reduction agenda consistent with the vision of a xiaokang society

Implicit in this call for a broadening of the poverty reduction agenda is the recognition that China has had tremendous success in the last quarter century in eliminating the most extreme forms of chronic poverty. During this period, China has also become much wealthier and more prosperous. Both developments suggest that China is now at the stage where it can take on the challenge of a broader poverty reduction agenda consistent with the vision of a xiaokang society that is better-off in an all-round way.

The changes and trends described above have not gone unnoticed in government circles. On the contrary, a number of recent policy initiatives indicate an increasing commitment of the government to a broader poverty reduction, social protection, and human development agenda. Key policy responses to the emerging challenges have been evident in recent years through such initiatives as:

- **The launch, in 2000, of the Western Region development strategy**, aimed at 'opening up the West', through construction of infrastructure, support for human capital formation, environmental protection, improvements in regional investment climate and local natural-resource-based industrial development.
- **Restructuring of poverty alleviation investments**. Area-based poverty investment programs were reoriented in 2001 with a shift in focus from the 592 designated national poor counties to 148,000 poor villages. This was partly in recognition of the dispersed nature of poverty, and the fact that many of the poor did not live in the designated poor counties and the poor counties also had many non-poor.
- **Development of the urban social security system**. While there is no official urban poverty line, the government has been rapidly developing an urban social security system following the economic restructuring of the public sector since the mid-1990s and the shattering of the "iron rice bowl". The new and evolving urban social security system has had three main elements: (i) assistance to laid-off workers (xiagang) from

state-owned enterprises, which has now been integrated with unemployment insurance, (ii) a means-tested minimum income support (Di Bao) program, and (iii) social insurance programs including pensions, medical, unemployment, work injury and maternity insurance.

The pace of efforts has quickened substantially since 2003:

- **Training program to support transfer of rural surplus labor.** In 2004, the government launched a multi-ministry program – called the Sunshine program for Training and Transferring Rural Labor Force – which provides short-term training to farmers leading to their transfer to non-agricultural employment often in urban areas. The program aims to train and transfer up to 40 million farmers by 2010.
- **Elimination of agricultural taxes.** The central government began to remove all local informal fee charges on farmers but raised the formal agricultural tax rate from 2-3% to 7% in 2002 to compensate partially for local revenue shortfalls. Local governments were subsequently asked to cut this tax rate by 1-2% per year, and by the end of 2006 all agricultural taxes and fees were fully phased out.
- **Supporting farm incomes.** During the 11th Five Year Plan period, agricultural policies have moved from net taxation to net subsidization of agriculture. Direct subsidies to agriculture, including grain and input subsidies (for fuel and fertilizers), increased 3.5 times between 2004 and 2007.
- **A nationwide rural social assistance system.** Perhaps, one of the most important developments has been the decision in March 2007 to set up a nationwide rural social assistance system—the Di Bao or minimum subsistence allowance program—financed in part by the central budget. A similar program—the urban Di Bao—has been in place in urban China since the late 1990s and currently provides income support to about 22 million urban residents. In rural areas, until recently only some provinces and counties had such an income support program. However, under the new initiative, the rural Di Bao program has been rolled out on a nationwide basis, and by the end of 2007, the number of rural Di Bao beneficiaries had grown to nearly 35 million.
- **A rural health insurance scheme.** Another major initiative has been the scaling up of the National Cooperative Medical Scheme (NCMS) in rural areas. The NCMS is a new voluntary rural health insurance scheme that is operated by counties and subsidized by the local and central governments. Introduced on a pilot basis in 2003, the NCMS has expanded rapidly to cover about 86% of all counties by the end of 2007.
- **Urban residents' basic medical insurance.** Complementary to the existing basic medical insurance scheme for urban formal sector workers, a new urban residents' basic medical insurance scheme was introduced in 2007 (following pilots in 2005) to expand urban health insurance to urban unemployed residents, students and children.
- **A medical assistance scheme in rural and urban areas.** A related initiative has been the rapid roll out of the Medical Assistance scheme in rural and urban areas to provide financial assistance to the poor and vulnerable groups in rural and urban areas with their health insurance contributions and copayments. Piloted in rural areas in 2003 and in urban areas in 2005, the scheme had expanded swiftly to cover all rural counties and 86% of cities by the end of 2007.
- **Compulsory education finance reform.** A major new initiative in education has been the introduction of free compulsory education. Introduced in March 2006, the compulsory education finance reform aims to promote universal primary and junior secondary education by repealing tuition/miscellaneous fees and textbook fees for all students, and by providing boarding subsidies to poor students (the so-called “two exemptions and one subsidy” policy). The reform is financed through large-scale intergovernmental transfers.

Substantial policy development and implementation is thus already evident along the lines of what could be considered a broader poverty reduction agenda. However, many challenges remain, and this report's assessment of both the evolving poverty situation and the key programs and policies suggests a number of priorities for further action.

What the review suggests about the main priorities for poverty reduction and what is needed to implement them

Adopting a broader conception of poverty and an adequate threshold for identifying and targeting the poor

It may be time for China to consider adopting a higher threshold for identifying and targeting the poor

To begin with, it may be time for China to consider establishing a higher threshold to measure poverty that could be consistently applied to both rural and urban areas. As suggested earlier, the current official poverty line of 785 Yuan per person per year at 2007 rural prices (or about 71 cents a day in terms of the 1993 PPP dollars or about 57 cents a day in terms of the new 2005 PPP dollars or about 31 cents a day using the current exchange rate) is arguably low – by international standards (in fact, it is one of the lowest in the developing world), relative to average incomes and growing aspirations within China, and even by the objective standard of the minimum expense currently needed to meet basic food and nonfood needs. The principle of a higher poverty threshold was endorsed by President Hu Jintao in his speech to the 17th Party Congress in October 2007. Adopting a higher poverty threshold is however only an initial step in the formulation of a forward-looking poverty reduction strategy. But it is an important first step as it can be critical for focusing policy attention on the right target group – one that is more appropriate for China's current stage of development. The new threshold should form the basis of not only the measurement and monitoring of poverty in the country, but more importantly, the development of a consistent operational approach to targeting a range of poverty alleviation and social protection programs to the poor in rural and urban areas.

It may be also worth considering measuring poverty in terms of consumption rather than income. While this report presents both income and consumption-based analysis, there are well-known reasons for preferring consumption over income, the main one being that consumption is a more stable measure of welfare. The emphasis on consumption is also in keeping with the current national goal of raising the share of consumption in GDP. Moreover, in the case of China, while many of the poor consume below their income levels, it is arguable that this is mostly in the nature of saving for a rainy day with a view to maintaining their consumption levels at a relatively stable level even as their incomes may fluctuate. This too suggests that consumption may be a more stable and reliable measure of welfare.

But the conception of poverty could also be broadened in two other respects. First, beyond income and consumption, access to affordable education and healthcare also ought to be seen as part of the poverty reduction agenda. Higher income and consumption can be a means for improving this access; however, income and consumption can themselves be limited by the lack of such access. The evidence suggests that inability to cope with health shocks is often an important factor in households falling into poverty, and limited human capital is often the reason for many households being unable to make use of the opportunities provided by economic growth to move out of poverty.

Second, since the contribution of (uninsured) risks to observed poverty is quite significant (estimated at about 40% for consumption poverty) and there are indications that this contribution tends to rise with further progress in poverty reduction, offering social protection to groups vulnerable to poverty also ought to be seen as an integral part of the poverty reduction agenda.

Thus, the poverty reduction agenda is broader than may be conventionally recognized. There are indications that in practice the government is already viewing the poverty challenge in such wider terms, but as discussed further below much still remains to be done in implementing this broader agenda.

Retaining rural poverty reduction as the top priority

Reduction of rural poverty should continue

Even with a broader conception of poverty, the evidence and analysis presented in this report suggests that the reduction of rural poverty should remain the top priority. Whether

to be recognized as a top priority

measured in terms of income or consumption, the poor in China are predominantly in or from rural areas. Even if migrant workers are not included in the rural population, as is commonly done in the national household surveys, rural poor account for about 90% of all those living below the poverty line. In contrast, depending upon the precise urban-rural cost of living differentials used to measure real incomes and consumption, urban residents (excluding migrants) account for 1-3% of the total number of poor in the country.

Table 0.3 : Rural-urban distribution of poverty in China, 2003

	World Bank poverty line				
	Share of population	Income		Consumption	
		% who are poor	Share of poor	% who are poor	Share of poor
Rural	72.5	9.5	99.2	17.9	99.4
Urban	27.5	0.2	0.8	0.3	0.6
Total	100.0	6.9	100.0	13.1	100.0

Source: See main report.

The rural-urban income gap has grown in recent years...

While income inequality within rural areas is somewhat higher than that within urban areas, the difference in rural and urban poverty rates largely stems from the widely-noted rural-urban gap in mean incomes, which has been steadily growing in recent years in both absolute and relative terms. Despite large-scale migration from rural areas, this gap is now at a historical high.

The rural-urban income gap is only one manifestation of the great divide that separates China's urban and rural areas

The rural-urban income gap is however only one manifestation of the great divide that separates China's urban and rural areas. On almost every dimension of welfare, the rural population lags behind the urban population. Literacy rates, enrollment rates (especially past primary school), and educational attainment rates (especially past junior high school) are all much lower in rural areas, and while there have been improvements in all these indicators in rural areas in absolute terms, the gap between rural and urban areas has continued to widen. Thus, rural poverty reduction must continue to be a top priority.

What perhaps has made these rural-urban differences so salient and a focus of considerable policy attention is the fact that in contrast to the significantly poorer outcomes for the rural population, the country's highly decentralized fiscal system continues to harbor an urban bias. On a per capita basis, let alone a per poor person basis, urban areas have much greater fiscal resources and these are reflected in correspondingly higher levels of public spending. For instance, in terms of publicly financed per-capita expenditures on education and health, rural areas lag far behind urban areas. Spending on social assistance and social insurance, too, is disproportionately higher for the urban population.

Several recent government initiatives are beginning to address the rural-urban imbalance

Recently, the government has taken several steps towards addressing the rural-urban gap. The major initiatives include: (i) the elimination of agricultural taxes and fees, and an increase in direct agricultural subsidies, (ii) the waiving of tuition fees for compulsory education in rural areas, (iii) a major expansion of rural health insurance to about 86% of counties nationwide, and (iv) a nationwide roll-out of the rural Medical Assistance scheme and the rural Di Bao program of minimum income support. These are all important initiatives which reflect increasing commitment of the government to addressing the rural-urban imbalance, and they are already beginning to be reflected in noticeable reductions in rural and hence national poverty levels. While they are unlikely to make a big dent in the rural-urban gap as urban areas continue to grow faster than the countryside, it will be important to maintain the momentum on these initiatives in future while also addressing several outstanding challenges (as discussed below) that will help deepen their impact on rural poverty reduction.

But it would be imprudent to ignore the urban disadvantaged groups

Also, while an emphasis on tackling rural poverty is entirely appropriate, it would however be imprudent to neglect the situation and problems of the relatively disadvantaged groups in urban areas. For several reasons. First, rural and urban poverty issues are now increasingly linked due to the large and growing flow of labor from rural to urban areas. Second, there could a degree of underestimation of urban poverty due to the inadequate coverage of migrant households in national surveys. Third, the urban labor market itself has undergone a profound transformation with the economic restructuring of the state and

collective sector since the mid-1990s that has exposed the urban working population to new vulnerabilities which if left unaddressed could lead to the emergence of an urban underclass or future urban poverty. With increasing urbanization, the development of a nationally integrated approach to both rural and urban poverty reduction and social protection is an increasingly important policy imperative.

Promoting opportunity by raising the returns to labor

In both rural and urban areas, inability to work is only a small part of the poverty problem

In both rural and urban areas, an inability to work is only a relatively small part of the problem. While it is true that households with someone who is unable to work – due to disability or old age – are more likely to be poor, nearly three-quarters of China's rural poor and all but 2% of the urban disadvantaged are in households where there is no lack of work capacity.

Raising the returns to labor—the main asset of the most of the poor—is therefore critical

What these households lack are adequate returns to their main asset, which is their labor, and what they need is greater and more rewarding employment. Raising the returns to the labor of the rural poor and the urban disadvantaged is, therefore, critical to promoting their opportunities for increased incomes and improved livelihoods. This can and is being done in several ways.

Realizing the potential of migration for poverty reduction

The scale of migration is large and has been growing rapidly

A promising avenue for rural poverty reduction has been through migration to urban areas. The scale of migration from rural areas has increased rapidly during the 1990s. While estimates differ depending upon data sources and definitions, the size of migrant population could be as high as 150 million making this the largest peacetime movement of people in world history. An idea of the scale and significance of this phenomenon could be had from the following basic facts (for 2003):

- Roughly one in every five rural workers is a migrant worker.
- About 43% of the rural population lives in households that have one or more migrant workers.
- The share of migrant income in total rural income is nearly 30%.

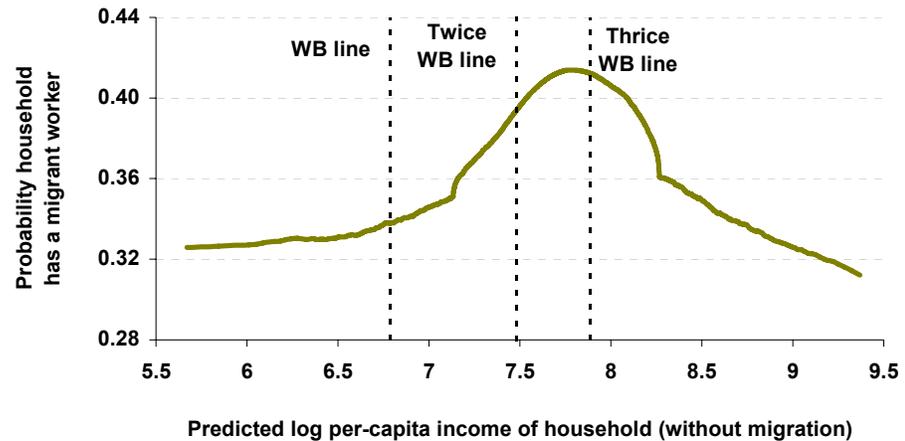
...and it has been poverty reducing

While it is difficult to precisely estimate the contribution of migration to poverty reduction, there seems little doubt that internal migration and remittances have played an important role in poverty reduction in rural areas. For instance, evidence from the NBS Rural Household Surveys indicates that households with migrant workers are (30%) less likely to be poor than households without any migrant workers. It is estimated that for 2003 alone, an additional 11.8 million persons would have been income poor in the absence of migration, or an increment in the total number of rural poor by 13%. And this is likely to be an underestimate as it does not take into account the indirect benefits of migration through productive investments supported by remittances or through the positive effects of migration on rural wages.

But many of the remaining poor are less able to migrate...

However, migration's effects on poverty are limited by the fact that many of the poor are unable to migrate. The relationship between migration probability (defined as the probability of a household having a migrant worker) and per capita income has an inverted-U shape (Figure 0.10). Both the poorest and richest are less likely to migrate although for different reasons. The rich have fewer incentives to migrate, while many of the poor are not able to make use of migration opportunities due to their limiting circumstances and endowments. Some of the key factors limiting migration include: the level of educational attainment of rural labor, limited access to information and labor recruitment networks especially where the informal (family and friends-based) networks are not well-established as in the case of certain minority communities, the expenses of movement and other costs associated with finding a job in cities, higher costs of health and education for migrants' children in urban areas which have been especially limiting of family as opposed to individual migration, and a degree of occupational and wage discrimination against migrants relative to local urban residents in relatively segmented urban labor markets.

Figure 0.10 : The relationship between migration probability and log income per capita at the household level, 2003



Source and notes: See main report.

... and migration is also creating some problems in source areas

While migration has been an important means of raising incomes of rural labor, it has also had some adverse consequences in source areas, including negative effects on educational attainments amongst the rural youth, greater vulnerability of households to work injury or disability of migrant workers, the problems of the left-behind children and the elderly, and the erosion of village cohesion and community participation. While some effects such as those on community participation may be difficult to mitigate in villages that have experienced a large-scale labor exodus, most of the others are indicative of policy failures related to factors such as relatively limited human capital of migrant workers, limited social insurance for migrants and their families, discriminatory rules and practices restricting migrant workers' access to urban services and ultimately limiting the scope for family migration.

In view of both the impediments to mobility that are particularly relevant to the poor, and some of the adverse effects in source areas, the potential of migration for poverty reduction remains under-realized. To better realize this potential, policy initiatives in several areas will be helpful.

- Improving the education and skill base of potential migrants especially those from poor households who are more deficient in these respects. Ensuring junior high school level of education for all in rural areas is a necessary first step. And in this regard, the recent introduction of free compulsory education is a very useful initiative. But beyond that there is also a need to increase public support for senior/post-secondary and technical education for the rural population if migrants are to be able to access better-paid higher skill jobs in urban labor markets.
- Providing assistance for reducing information and search costs associated with migration by supplementing informal social networks with more organized placement and intermediation services. A special effort is likely to be needed to reach some of the minority groups, and those in some of the poor areas where existing informal networks are underdeveloped.
- Improving investment climate in cities in the main sending regions in Central and Western provinces. The pattern of migration in China in many ways mirrors the geographic concentration of economic activity. The sending areas are concentrated in the Center and the West and the receiving areas along the coastal belt in the East. Most migration is inter-provincial and over long distances. However, like elsewhere in the world, distance increases the costs of migration, and reduces its magnitude. At the same time, the industrial clusters in the coastal belt are becoming increasingly skill and capital-intensive. Hence, developing the relatively more labor-intensive

segments of industry in the central and western provinces can play a useful role in promoting further absorption of rural labor. This in turn will require several steps to improve the investment climate in these areas.

- Improving labor market conditions and the provision of public services and social security for migrants in the cities. Despite its large scale, the current system of migration could with some justification be described as a 'guest worker system'. A range of discriminatory practices in destination areas abridge migrants' entitlements as workers or citizens. There is an increasing need to eliminate these practices which are limiting both the scale of migration, especially family migration, and the potential welfare benefits from migration. In particular, this will require better enforcement of the provisions of labor laws for migrant workers, access to basic services (education, health and housing) to be determined on the basis of place of residence rather than the place of hukou, and the extension of the coverage of social protection programs to migrant workers. Insofar as this promotes family migration, this will also help address the problems of the left-behind children.

● Government initiatives in some of these areas are already underway as, for instance, laid out in the Opinions of the State Council on Issues Concerning Rural Migrant Workers (SC Document No. 5, March 2006), and the MOLSS Circular on the Implementation of SC Document No. 5 (April, 2006) as well as the action plans of the inter-ministerial Joint Conference on Rural Migrants Issues established in 2006. The long list of policy guidelines for migrant workers cover many areas including worker rights and protection, public services and living conditions, social security, employment services and skills development. However, not much systematic information is available on the actual implementation of these wide-ranging guidelines. It will be important to monitor the progress on these new initiatives not only to assess if they are being implemented as intended, but also to refine the different initiatives based on the implementation experience of what seems to be working, where and in what ways.

Promoting agricultural and rural development in poor areas

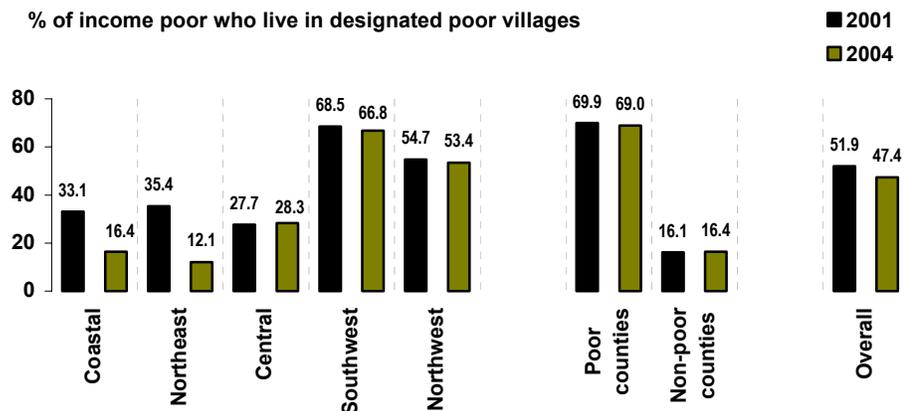
Promoting agricultural and rural development has a role within a poverty reduction strategy

However, migration will not be the answer for all the rural poor. There is clearly a role for promoting agricultural and rural development within a poverty alleviation strategy, as also suggested by the analysis of the taxonomy of rural poor presented in this report. And this has also been a key element of the government's approach to poverty alleviation which from the outset has been development-oriented and targeted to poor areas. China's flagship poverty alleviation program, the Integrated Village Development Program (IVDP), is an area-based program that currently targets about one fifth of all Chinese villages (that are designated as poor villages) using a participatory approach to village investments. Other important developmental poverty alleviation programs include subsidized credit and development of agribusiness, the food-for-work program and a labor transfer program which in fact seeks to promote migration.

But area-based programs are unable to target the poor effectively and the impact on incomes of the poor who are targeted is small

The review of these programs in this report highlights several areas for potential improvement. In relation to the integrated village investment program (IVDP), the review highlights two key issues: (i) the relatively poor targeting of the program (a large fraction of the poor simply do not live in designated poor villages), and (ii) the very limited impact of village investments on incomes of the poor within designated villages (reflecting the relatively small scale of investments, the inability of many of the poor to make complementary investments, and a number of factors linked to limited participation of villagers, especially the poor, in the planning and implementation of projects). Besides the IVDP, the subsidized credit program, although accounting for about half of all poverty alleviation funds, is not set up in a way to deliver significant benefits to the poor as its main focus has been to support large agribusiness enterprises. And participation of the poor in the training programs for labor transfer has also been limited by the relatively high costs of participation.

Figure 0.11 : Fraction of the income poor living in designated poor villages
(Fraction of the income poor living in designated poor villages, by region and overall)



Source and notes: See main report.

To make them more effective instruments for rural poverty alleviation, further reform of these programs will be needed. For the IVDP, the following areas merit consideration:

- Develop consistent, data-based criteria for selecting poor villages and a system for updating poor village designations; privilege poorest villages for earlier and larger investments.
- Increase the size of village investments. This may require higher funding for the budgetary grant program, but the effective size of village investments could also be increased through improved coordination of fund disbursement for village plans by designing clear rules to guide the aligning of Food-for-Work investments and subsidized credit with village plans. There is also scope for releasing more funds per village by targeting fewer villages.
- Develop institutional mechanisms to improve coordination of village investments with other line agencies. Since the larger part of investments in rural areas comes not through the poverty alleviation funds but through the budgets of other line agencies, the needs for better coordination of village-level investments goes well beyond the poverty alleviation funds themselves. The current institutional mechanism for inter-agency coordination through the local Poverty Alleviation and Development offices works only imperfectly, and needs considerable strengthening to be effective.
- Place new emphasis on household-level targeting, as even with better identification of poor villages, it will be important to reach the poor within these villages. This can be done in several ways: by changing the mix of projects to include more household-oriented interventions, for instance, labor training to promote off-farm employment; by waiving the requirement for complementary investments by poor households or providing subsidized credit for this purpose; by developing new programs such as self-targeting public works programs or conditional cash transfers which could offer assistance to poor households conditional on other objectives, for instance, ensuring that their children do not drop out of school, or they themselves participate in labor training.
- Conduct additional study of the village planning process to identify ways to increase participation of the poor, and experiment with new methods of implementing village plans.

For the other developmental programs, too, there are several areas for potential reform that may be considered:

- The subsidized credit program needs to be integrated with the village plans. New institutional arrangements will be necessary for this to happen; simply exhorting different agencies to coordinate better will not help. It also needs to be recognized that village-level coordination of funds and program management is unlikely to succeed without coordination at the county and provincial levels. There should thus be a single agency that is adequately empowered to ensure this coordination at the

provincial and county levels.

- There is a need to redirect subsidized credit from large agribusiness enterprises (which ought to be supported through the regular commercial banking networks) to poor farmers, in part through provision of cheap loans for complementary investments by them to better utilize the public goods created by village investments.
- In relation to the labor transfer programs, boarding and other expenses should be waived for poor farmers to ensure their enhanced participation.

Further gains from better geographical targeting are limited ... hence the case for household-oriented approaches and new targeting mechanisms such as proxy means targeting

Two further policy considerations about developmental poverty alleviation programs should also be noted.

- Even with perfect village-level targeting, many of the poor will be left out (due to the increasingly dispersed nature of poverty) and many of the benefits of investments in targeted villages will flow to the non-poor in these villages. There are thus limits to further gains from area-based targeting and it will be important to supplement area targeting with household targeting. But new mechanisms will need to be developed to target poor households, and in this regard approaches such as proxy-means targeting deserve to be actively explored.

More household-oriented interventions will raise the stakes of inter-agency coordination of developmental and social protection programs

- If, as suggested above, more household-oriented interventions are to be adopted as part of these developmental poverty alleviation programs, then the issue of coordination with social assistance and social insurance programs, which also provide critical support at the household-level, will become increasingly important. For instance, there will be a need for a common approach to identifying poor households by both the developmental and social protection programs, which raises the stakes of inter-agency coordination not just to the Poverty Alleviation Offices, Departments of Finance and Development Reform Commission and the ABC (or Rural Credit Cooperatives), but also the Departments of Civil Affairs and Labor and Social Security. The development of a coordinating mechanism for this related set of poverty reduction interventions remains a big institutional challenge.

Enhancing security by expanding and improving the coverage of the social protection system in rural and urban areas

The evidence presented earlier in this report indicates that rural and urban households in China remain vulnerable to poverty because they are exposed to a variety of risks arising from natural disasters, ill-health, fluctuations in agricultural yields and prices, and job loss. In rural areas, for instance, the size of population vulnerable to poverty may be twice as large as the number of poor in any given year. Social protection systems – through social assistance and social insurance programs – help individuals cope with such risk and vulnerability, and hence the development of such systems is an integral part of the overall poverty alleviation strategy.

China has come a long way in reestablishing its rural and urban social protection systems, but many policy challenges remain

China has come a long way in reestablishing its rural and urban social protection systems after the collapse of the traditional commune and enterprise-based systems during the process of economic reforms and restructuring of the 1980s and 1990s. Major revamping of the urban system started in the mid-1990s while the rebuilding of the rural system has been the focus of more recent policy attention especially over the last five years. While the substantial development of the new social protection system over a relatively short period of time is impressive, this has happened in the context of massive structural change in the rural and urban economic systems, and there remain many policy challenges. Drawing upon the analysis presented in this report, the key challenges and potential areas for reform for the rural and urban systems are noted below.

Improving rural social protection

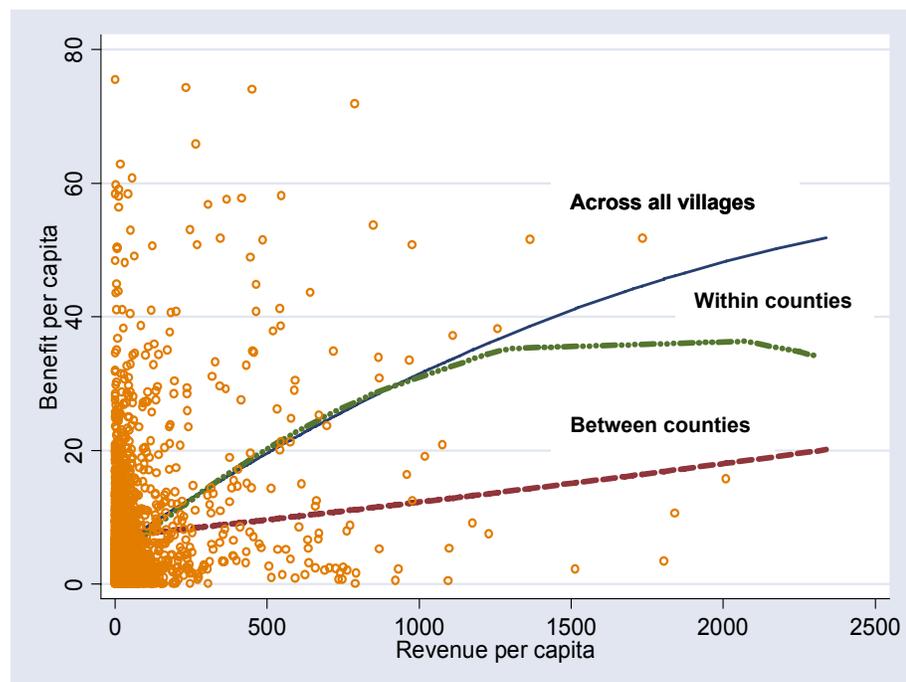
Over the last 3-4 years in particular, there has been significant progress in the expansion of several elements of the rural social protection system, which is beginning to address its longstanding underdeveloped state. The recent initiatives are consistent with the recognition that access to land alone, despite the relatively egalitarian distribution of use rights, cannot be relied upon to provide an effective rural safety net. The main thrust of

these initiatives has been on expanded coverage, and as a result, the coverage of key programs, in particular the rural Di Bao, rural health insurance and the Medical Assistance scheme, has rapidly improved. At the same time, however, the coverage of other programs such as rural pensions and disaster relief remains limited, and the benefit levels of most rural programs are quite low. This is in contrast to the urban sector where following the major restructuring of the state-owned enterprises during the 1990s, a much greater level of government effort and resources have been devoted to the development of a relatively modern non-enterprise-based social welfare system. The recent progress is starting to bridge the gap between the rural and urban systems, but much still remains to be done.

Overall, there remain four major challenges for the rural social protection system.

- The coverage (in terms of the number of beneficiaries as different to the number of implementing counties) of several programs needs to be expanded to more fully cover the rural poor and vulnerable population.
- The benefit levels of most programs, which are only a fraction of the benefits under urban programs, will also need to rise if they are to offer effective protection to those covered by the programs.
- There is a need for coordination and harmonization of different programs within the rural social protection system as well as between the rural and urban systems. A harmonized national system is important not only for bridging the rural-urban gap in the social protection, but also for ensuring adequate protection to migrant workers who are currently only imperfectly covered by the rural and urban systems.
- All this will require further infusion of funds from the central and provincial governments. Such commitment of resources from higher levels of government is also needed to break the dependence of social protection spending on local fiscal capacity, and hence address the wide disparities in both the coverage and benefit levels of programs within rural areas due to the large differences in the revenue base of local governments (Figure 0.12).

Figure 0.12 : Social assistance benefits depend on village revenues, 2004



Source and notes: See main report.

There are specific challenges for individual programs.

- **Rural Di Bao:** The rural Di Bao has clearly emerged as the main focal assistance program for rural areas. Its rapid expansion since 2005 has been impressive with gross coverage rate now equivalent to about two-thirds of the number of rural poor. However, as it expands further, the program will need to be streamlined with a more consistent approach to coverage and targeting. Here, many of the challenges will be of a similar nature to those already being encountered with the more established urban Di Bao program (see further discussion below), namely, realizing the scope for better targeting and hence improved coverage of the poor, rationalization of Di Bao lines and eligibility criteria across different local governments so that program coverage is better aligned to needs rather than local fiscal capacity, and development of a benefit design framework that limits adverse work incentives.
- **Rural health insurance:** The recent rapid expansion of rural health insurance is indicative of its recognition as an important priority for the government. With an estimated participation rate of 86% at the end of 2007, the coverage issue has been largely addressed. The next challenge will be to ensure the provision of an adequate level of benefits that can secure a sizeable reduction in the burden of private health costs. The targeted increase in the budget through a doubling of contributions in 2008 will help provide more resources for raising benefit levels, but further increments of funding from central and provincial governments will be needed for net reimbursements to cover a larger fraction of the out-of-pocket health costs. Coverage of outpatient services also remains a further challenge. Another major challenge is the coverage of migrant workers who seem to be left out by both the urban and rural health insurance systems, and this raises the broader challenge of the coordination and harmonization of two systems, which is all the more pertinent now as the NCMS is beginning to operate at a national scale.
- **Medical Assistance:** The Medical Assistance program is a useful supplement to the rural health insurance scheme in extending the latter's coverage to the rural poor. However, despite its recent scaling up to the national level, its coverage in terms of the number of beneficiaries is still relatively limited; the gross coverage rates are equivalent to about half the number of rural poor. Moreover, its relationship with the Di Bao program will also need to be clarified. As both programs target the poor, there is a need for a unified approach to targeting assistance. The government may also want to consider using the MA scheme to introduce a means-tested safety net provision to health insurance whereby after reaching a certain threshold of per capita healthcare expenses in any year, the insured are entitled to higher (even 100%) reimbursements.
- **Disaster relief:** Additional government resources will be needed to improve the coverage and benefit levels of disaster relief which remain limited relative to the scale of the problem. However, most of the government response is ex post in nature and there is a conspicuous absence of disaster insurance. Recently, China Life (China's largest life insurer) launched the county's first accident insurance covering six types of natural disasters. However, the private uptake of such insurance may be limited, and there is a strong case for the government to consider public provision of disaster insurance with subsidized premia for the low-income groups.
- **Rural pension system:** The reach of rural pension program remains limited and uneven. A significant expansion of the program along the lines being considered by the government will entail a high degree of "subsidization" with a much larger government contribution (into individual pensions). Such a highly subsidized program however makes it more like a transfer or assistance program for the rural elderly. There is thus a need for a careful evaluation of different options for providing support to the elderly while recognizing that social insurance programs need to be considered together with social assistance programs.

Improving urban social protection

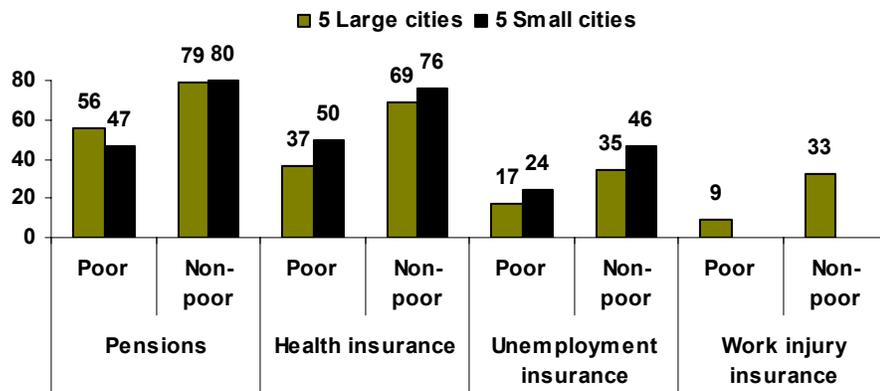
While the urban social protection system is substantially more developed than the rural system, there remain many areas of concern in relation to the ability of the core programs to serve as an effective safety net for the urban population. The review presented in this report identifies several challenges for both social insurance and social assistance

programs in urban areas.

Key policy challenges and areas for reform for urban social insurance programs include the following.

- Limited coverage, especially of the poor and lower income groups and those in informal employment.** Despite the expansion over the last decade, the coverage of urban social insurance programs still remains limited. Currently the key programs cover between 40-50% of urban workers which indicates that there is a lot of ground to be covered still. The system is also heavily focused on the formal sector, and coverage rates for informal workers are much lower still, often as low as one-fourth of those in the formal sector. Similarly, the coverage rates for the poor and low-income workers are a fraction of those at the upper end of the distribution. Further expansion of the system needs to pay particular attention to better coverage of these groups (Figure 0.13).

Figure 0.13 : Lower coverage of social insurance for the poor in Chinese cities, 2005 (% of workers with various forms of social insurance coverage)



Source and notes: See main report.

- Limited coverage of migrant workers.** Large-scale rural to urban migration continues to pose challenges for the urban social protection system. The coverage rates for pension, health and unemployment insurance for migrants are estimated to be about one-seventh of those for local urban residents. Since 2006, there has been a significant momentum on the extension of work injury and health insurance which, according to administrative data, covered about a third and a quarter of migrant workers respectively in 2007. However, much still remains to be done in these two areas. The inclusion of migrants in pension and unemployment insurance is more limited and poses a bigger challenge as the design of these programs is not well-suited to serving a mobile labor force that changes employers and jobs more frequently.
- Low level of pooling of social insurance funds and very limited portability of benefits.** The contributions into most social insurance funds are typically pooled only at the local government (municipality or city) level. Low level pooling is however inefficient from a risk management perspective and limits the insurance benefits of the programs. It also has the effect of creating inequities in the system by tying local social insurance expenditures to local revenues. Low level of pooling also goes hand in hand with very limited portability of benefits. This is not only a significant barrier to improved coverage of the programs, but is also a major impediment to labor mobility and the development of a flexible labor market. Progress towards higher level pooling and greater portability has remained limited. Higher levels of pooling can be unattractive to richer local governments who may view it as an implicit tax. The reform of the system is thus likely to be difficult, but remains an important area for future policy development.
- Need to balance provision of greater protection with maintaining incentives and**

competitiveness. The urban social insurance system is costly with its financing by employers and employees accounting for about 43% of the wage bill. The employers' contribution for the five key programs alone comes to about 32% of the payroll. Some of this may be passed on to the workers in lower wages, but private incentives for non-compliance remain high. Incentives for non-compliance also exist for the poorer workers. These factors are already contributing to the informalization of the urban labor market. The existing system also has important implications for maintaining competitiveness of Chinese business and industry. Greater effort at enforcing compliance, though desirable, is unlikely to be enough to tackle the dual problems of informalization and ensuring competitiveness. A part of the solution will almost certainly involve greater public funding of the social insurance system. To protect the interests of the poorer workers, the government may also consider reducing or waiving the employee contribution and even reducing the employer contribution for workers below a certain income threshold.

Urban Di Bao. The main social assistance program for the urban disadvantaged is the urban Di Bao program. By international standards, the program is exceedingly well-targeted with 64% of the program beneficiaries in the bottom decile of the urban population who account for about 70% of program benefits. While such performance is exemplary, the review of the program in this report suggests that it still faces a number of policy challenges, the most important of which include: (a) limited coverage of the urban poor (bottom 5-10% of the urban population) despite overall excellent targeting in terms of concentration of benefits amongst the bottom end of the distribution, (b) non-coverage of the migrant population, (c) eligibility thresholds (Di Bao lines) and benefit levels varying with local fiscal capacity rather than need, and (d) potential work disincentive effects of the program design.

In view of these challenges, several areas of reform are suggested; many of these also have relevance for the rural Di Bao program.

- One area of potential reform is in relation to the rationalization of Di Bao lines. There is a case for eliminating inequities in the system by establishing a set of eligibility lines that refer to comparable standards of living across locations. If it is not possible to develop city-specific lines with the currently available data, consistently-estimated provincial eligibility lines could be a useful starting point. This approach will also delink Di Bao lines from considerations of local fiscal capacity. However, such a reform can only be effective if it is supported by transfers from higher levels of government to poorer municipalities. Central funding to provincial and local governments will thus need to be based on the estimated number of beneficiaries using the consistent set of eligibility lines.
- A related issue is the rationalization of Di Bao benefit levels which too vary significantly across cities and municipalities in a manner that is related not to differences in the depth of poverty but to what the local governments can afford or are willing to fund. Recent regulations (in February 2008) to raise the benefit levels, for instance, also permit better-off areas to implement higher increases. A more nationally consistent and equitable approach is clearly needed.
- Improving the coverage of the poor will need a further expansion of the program in areas where coverage has been limited by relatively low thresholds. But it will also require improved methods of targeting such as proxy-means targeting. Household incomes are difficult to observe and measure accurately, and some form of implicit proxy-means targeting is already being practiced by the neighborhood committees as evident in the use of various non-income criteria. While the implicit proxy-means mechanism appears to have worked reasonably well thus far, many of the urban disadvantaged remain excluded. Hence, there is a case for developing a more explicit proxy-means targeting system based on relatively easily-observed household characteristics that are correlated with income. The list of household characteristics could include indicators related to household demographics, labor force participation, any work disability, educational attainment of adult members, ownership of specific assets, and characteristics of dwellings, amongst others. There is now a good deal of international experience with proxy-means targeting that could be drawn upon in developing a system tailored to China.
- Coverage of the migrant population needs special attention. Migrants include both

individual migrant workers and migrant families. As a first step, extending Di Bao coverage to migrant families who have been resident in an urban area for some minimum period of time and meet the program's means test ought to be considered. Until such time that the urban and rural Di Bao programs can be coordinated, individual migrant workers may have to be covered under rural Di Bao through their families in rural areas.

- There is also a case for reconsidering the top-up design formula for the determination of Di Bao benefits. Such a design implies a 100% marginal tax rate on incomes of those eligible for the program. The reason why the program has managed to avoid serious adverse effects on work incentives thus far is that the top-up design appears not to have been followed in practice. Thus, the actual implementation practices are already pointing to the need for an alternative benefit structure. One alternative here is uniform per capita benefits for those eligible. While this is attractive for its simplicity and transparency, uniform benefits may not be considered sufficiently progressive. Another alternative could be to base benefits on the proxy-means scores of households, with lower benefits for those with higher scores but calibrated so as to maintain relatively low marginal tax rates.

Harmonizing the rural and urban systems

As already mentioned, the overall social protection system is still more focused on the urban formal sector, despite the recent expansion of the rural system. At the same time, with the growth in the rural system, the issue of the integration of the rural and urban social protection systems has become increasingly important, not only to close the gap between the two but also to promote a more flexible labor market environment and to facilitate the coverage of migrant population. The harmonization of the two systems may need to proceed in a phased manner. By capping urban benefits at current levels and gradually raising rural benefit levels over time, conditions can be created for the eventual integration and harmonization of the two systems.

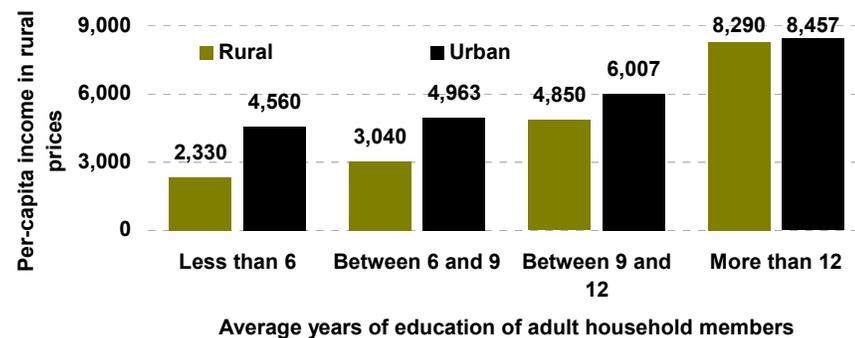
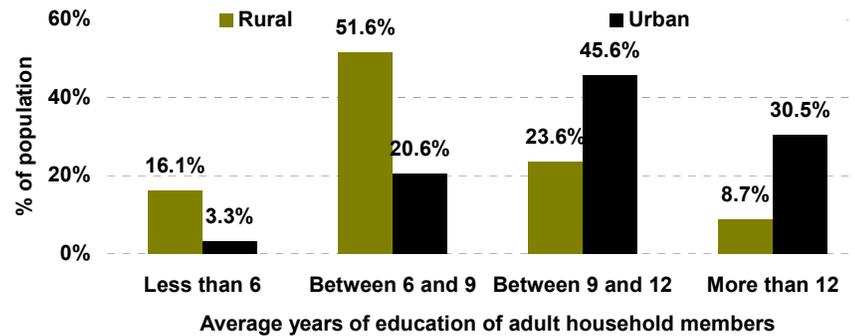
Fostering equity and reducing poverty by ensuring secondary school education and basic healthcare for all

A large part of the current poverty and inequality in China can be traced to the underlying disparities in educational attainment

The analysis presented in this report has repeatedly found education to be of critical importance in determining better welfare outcomes for China's population.

- The educational attainment of a household's adult workers is the clearest observable predictor of poverty in China, in both rural and urban areas. While the poor differ from each other in other ways, low levels of educational attainment seem to be common to virtually all of them. A high school education for the adult working members virtually guarantees a household's exit out of poverty. Even with middle school education of adult workers, consistent with the goal of ensuring universal 9-year education, the probability of being poor declines to negligible levels. At the same time, over 90% of the poor in rural areas and nearly 60% of the disadvantaged in urban areas live in households where this target has not yet been attained. Investing in middle and high school education for all is thus the key to making a substantial dent in remaining poverty.
- In terms of explaining income inequality too, differences in educational attainment, and the returns to education, turn out to be critical. The components of inequality that contributed most directly to the rise in inequality—the rural-urban gap and increasing inequality within rural and urban areas—can all be traced to inequalities in human capital (Figure 0.14).

Figure 0.14 : Differences in human capital endowments and returns underlie much of income inequality between and within rural and urban areas, 2003



Source and notes: See main report.

- As already noted, at least a junior high school level of education is an important determinant of migration and off-farm employment for rural laborers, and higher level of education will be important for migrant workers to tap into higher-skill and better-paid jobs in the cities.
- In urban areas, the rising inequality in labor incomes can in turn be traced to, on the one hand, the increased incidence of unemployment and declining labor force participation associated with the massive restructuring of state-owned enterprises, and on the other, to increasing dispersion in wages among those who are employed. Educational attainment has played a central role in both processes by determining who were most likely to retain their jobs in the face of widespread layoffs, who were most likely to be re-employed after an unemployment spell, and who were likely to be paid more when employed.
- A large part of the gender income gap can be traced to differences in educational attainment of men and women.

While private returns to education have increased with economic reforms and rapid growth of the Chinese economy, the persistence of underlying disparities in educational attainment suggests that the improved private incentives for greater investment in human capital are not enough especially for the poor. Since social returns to education are even higher than private returns, there is a strong case for greater subsidization of education.

Unequal access to basic healthcare also remains another major policy challenge

Another major area of policy challenge that has been opened up by China's wide-ranging economic reforms during the 1980s and 1990s is in relation to provision of basic healthcare.

- Despite significant income poverty reduction over the last 25 years, China's progress in improving health outcomes (for instance, child mortality and communicable disease mortality) has slowed down.
- Private costs of healthcare have risen dramatically (even for those who are insured)

and are impinging on the utilization of healthcare services.

- Health shocks and the burden of medical expenses and the loss of income they entail, are one of the most common reasons why households fall into poverty.
- With only the well-off being able to afford reasonable quality healthcare, inequalities in income are transmitted to those in health outcomes. There are thus large disparities in health outcomes between urban and rural areas and between the rich and the poor within both urban and rural areas.

Ensuring that every household has access to education and healthcare thus remains an important part of the current poverty reduction agenda and is also critical fostering greater equity. The government is already responding to this challenge in a number of ways, but a lot more remains to be accomplished.

Improving access to affordable education

- Recently, good progress is being made in universalizing 9-year compulsory education. The waiving of school fees and the provision of boarding subsidies under the compulsory education finance reform, introduced in rural areas in 2006 and gradually extended to urban areas in 2007, is an important step in the right direction. The momentum on this initiative should be maintained so as to achieve the goal for 2008 of achieving free compulsory education nationwide. It will also be necessary to ensure that this policy can be implemented through China's decentralized fiscal system on a sustained basis. Poorer local governments (at the provincial and sub-provincial levels) will thus need to be adequately resourced, which in turn will be important for ensuring that free compulsory education does not come at the expense of a compromised quality of education.
- There is also a need to review the formula for compulsory education transfers, which should be allocated more equitably based on needs rather than the pre-existing level of fees.
- The impact of the policy of school consolidation and the closure of teaching points needs to be reviewed. While the government has indicated the closures will be subject to prior community consultation, the implementation of this provision needs to be monitored and if the closures are likely to compromise school access in particular areas, the policy should be suitably amended.
- A solution needs to be found for the problem of school debts perhaps by allowing a fraction of the transfer to go towards debt repayment.
- China has achieved close to universal primary education. But significant inequalities in educational attainment beyond primary school – middle and high school, and eventually tertiary education – remain, and these are an increasingly important source of disadvantage for those who are not well-off. While middle school education is being covered by the compulsory education initiative, there is a need to turn attention to reducing the private costs of high school education especially for the poor. Means-tested subsidies for high school education could be an important future policy initiative, and these could be offered to poor households conditional on school attendance by their children, especially girls.
- There is also a case for developing a credit market for education where students (or their parents) can borrow for investments in education against future earnings. And the subsidies could of course be combined with loans for education. There are several examples of the application of this approach internationally and drawing upon that experience China could develop a model suited to its own conditions.
- The education of children from migrant families in urban areas remains an area of particular concern. While steps have been taken over the last few years (especially since the State Council Document No. 5 of March 2006 and the inter-ministerial Joint Conference on Rural Migrants Issues) to reduce effective educational discrimination against migrants, progress remains uneven across urban areas and the implementation of non-discriminatory practices needs to be further monitored and consolidated.
- There also remain large differences in the quality of educational inputs across regions, especially across rural and urban areas. Further investments into Improving

the quality of educational inputs in rural areas will help strengthen the demand and private incentives for education which in turn will be important for addressing the rural-urban education gap.

Improving access to affordable healthcare

Significant progress has been made in recent years in extending the coverage of basic healthcare to the Chinese population. Important initiatives in (i) rapid expansion of the coverage of rural health insurance to nearly 86% of counties in the country, (ii) expansion of the Medical Assistance scheme in rural and urban areas, (iii) the introduction of the Urban Resident Basic Medical Insurance in 2007 have all helped the country move forward towards the eventual goal of universal healthcare provision. Many of the remaining challenges have already been referred to above, and most importantly, include the following:

- While the coverage of rural health insurance has now expanded to include the bulk of the rural population, the level of benefits (net reimbursement) needs to be increased to achieve a sizeable reduction in out of pocket expenses. The current government contribution of 40 yuan per person is clearly quite limited. In 2008, the government contribution was raised to 100 yuan per capita. However, this is probably still not enough. For instance, in 2006, rural households on average spent 192 yuan per person on healthcare and medical expenses, and even the bottom quintile spent 118 yuan. Thus, the standard should be gradually raised further. At the same time, the coverage of rural health insurance needs to be broadened to include outpatient services.
- The recent rapid expansion of the Medical Assistance program is also laudable. There is however scope for further expansion of coverage beyond the 29 million rural and 4 million urban participants in 2007. As noted above, the relationship of MA to the Di Bao program also needs to be clarified with a view to establishing a unified approach to targeting assistance to the poor and the disadvantaged. The MA program could also be used for a means-tested safety net provision under health insurance for higher or even full reimbursement of healthcare expenses above a threshold.
- In urban areas, the introduction of the new Urban Resident Basic Medical Insurance should help improve the inclusion of those in the growing informal sector whose participation in the largely formal-sector focused health insurance has been quite limited. The 41 million enrollees under this scheme by the end of 2007 is encouraging but still limited relative to the size of the informal sector.
- The effective inclusion of migrant workers in health insurance remains an area of concern. The directions from MOLSS in May 2006 to set up a separate medical insurance pooling fund to mainly cover inpatient expenses for migrants, and to improve the settlement method for those in the urban system who return to their hometown for treatment or others in the rural system who seek treatment in urban areas, are indicative of the government's intent to address this issue. But the case of the migrant workers highlights the larger policy issue of the integration of rural and urban health insurance. This issue is all the more pressing with the recent expansion of both the rural and urban systems. There is also a risk of excessive fragmentation of health insurance with different schemes with varying provisions covering different segments of the population and the lack of an effective mechanism for portability across schemes. Though a difficult issue, complicated further by disparities in fiscal capacity under the decentralized fiscal system, it is one that will need to be confronted in future policy development for universal healthcare.

Supplementing area-based poverty reduction efforts with a household-oriented approach

Supplementing area-based poverty reduction efforts with a household-oriented approach makes sense...

Implementation of the broader poverty reduction agenda outlined above will require supplementing the traditional area-based poverty reduction efforts with household-oriented approaches and interventions. The case for a household-oriented approach has already been mentioned in the context of the government's poor village-based IVDP program. But a focus on household-oriented approaches has a broader cross-cutting

relevance for the entire poverty reduction agenda.

...for several reasons

There are several related reasons why such a focus makes sense.

- The large and growing scale of labor mobility has diminished the promise of exclusively area-based approaches for poverty reduction. With greater prospects of migration, it has become relatively more important to invest in people (who are increasingly mobile) rather than the areas they come from.
- The remaining poor are more dispersed throughout the villages of rural China, and as already noted this is one of the reasons why an area-based approach such as the one used in the IVDP program for designated poor villages is likely, even with a better identification of poor villages, to miss reaching many of the poor.
- The poor are also a heterogeneous group. They are poor for multiple and varying reasons related to their particular household endowments and circumstances, not all of which are reducible to where they live. A taxonomy of poverty suggests that several different clusters of poor can be identified depending upon different mix of factors underlying their poverty. Some of these factors are common to most, if not all, of the poor. Almost all the poor live in households where the adult workers are poorly educated. Few of the poor have access to employment off the farm. But the other reasons for poverty are more varied, and are relevant only for particular sections of the poor. In the case of some, it is that they have limited land to work with; others may be poor because of the burden of family members who are incapable of working; for still others their minority status may be a source of additional disadvantage. A household-oriented approach is needed to address this heterogeneity.
- Virtually the entire social protection agenda consists of interventions that are intrinsically household-oriented. Whether it is social assistance programs such as the rural and urban Di Bao, or social insurance programs such health or unemployment insurance, they are all directly targeted to households.
- Finally, even within the context of area-based development-oriented programs, there is a case for supplementary targeted household-level assistance to enhance the poverty impact of these programs. The evidence indicates that without such direct assistance, the poorest households do not benefit. It is thus recommended that China's area-based poverty programs place new emphasis on household-level targeting, and incorporate a broader range of instruments for providing direct development-oriented assistance to poor households. These might include subsidies for complementary investments to make public goods more accessible to the poor, as well as development of new programs such as conditional cash transfers to increase rural school attendance, or self-targeted public works programs.

Investing in the development of a unified targeting system such as proxy-means testing could have large payoffs

Greater focus on household-oriented approaches to poverty reduction also raises the importance of developing suitable household targeting mechanisms to reach the poor. The common challenge faced by current programs, whether it is area-based interventions, labor training for migrants, subsidized credit, or various social assistance or insurance programs, is their ability to reach the poor and the disadvantaged. As discussed at several points in the report, there is significant scope for improvement of current targeting mechanisms, and there is a need for a unified approach to targeting the wide range of ongoing programs, many of which have expanded substantially in recent years. In particular, there is a case for considering mechanisms such as a proxy means targeting system at least on a pilot basis. Investing in the development of such a system could have large payoffs as the same underlying system could be employed to target multiple programs, perhaps with the use of different thresholds and ancillary criteria for individual programs. Even if a proxy means system is not directly used to determine program eligibilities, it could serve an important role in the verification of currently used forms of screening and means testing, and thus help improve the overall targeting effectiveness of different programs.

Providing an adequate and equitable allocation of resources for local governments

A more adequate and equitable allocation of resources for local

In China, as in most of the world, local governments are at the frontlines of service-delivery, social protection, and poverty reduction. However, unlike in much of the world, within China's highly decentralized fiscal system, local governments at the county level

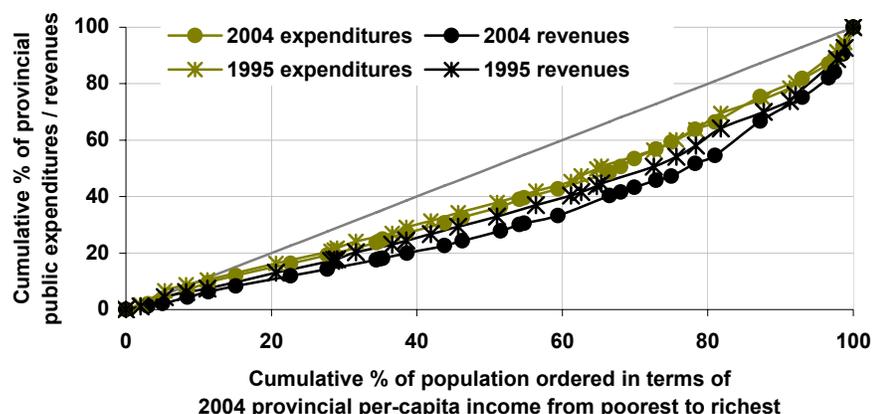
governments is needed

and below, as well as village collectives, also bear the primary responsibility for financing these efforts. But local governments in China vary widely in terms of their revenue-raising capacity, and the variation is only partially mitigated by transfers from higher levels of government. The resulting large disparities in fiscal resources across local jurisdictions translate into large disparities in levels of public spending. And that in turn leads to large differences in the quality and level of services provided, in the extent of social protection and unevenness in the pace of poverty reduction, thereby contributing to the persistence, and even magnification, of inequalities. Implementing the broader poverty reduction agenda and ensuring that local governments all across China have the resources to provide a basic nationally determined level and quality of services and social protection to those living within their jurisdictions will require a more equitable and adequate allocation of resources for local governments.

This is a two-fold task. There is certainly a need to move towards a more equitable allocation of resources through further equalizing transfers. The evidence indicates that the pattern of public expenditures favors richer provinces, and within provinces, richer local governments. For instance, at the provincial level while transfers from the center have been equalizing, but because the disparity across provinces in revenue-raising capacity has grown noticeably during 1995-2004, provincial expenditures in 2004 still favored richer provinces as much as they did in 1995 (Figure 0.15).

Figure 0.15 : The provincial distribution of expenditures in 2004 favored the richer provinces

(Concentration curves of cumulative % of expenditures/revenues)



Sources and notes: See main report.

Disparities below the provincial level tend to be more pronounced, even for poverty-related expenditures

Spending disparities below the provincial level tend to be even more pronounced. Data from the Special Purpose Survey of 3036 villages, undertaken jointly by the NBS and the World Bank for the purposes of this poverty assessment, indicate that the village-level distribution of social assistance and infrastructure investment expenditures is much less pro-poor than the provincial distribution would suggest.

Much, therefore, still remains to be done in terms of making poverty-related public expenditures more equitable and pro-poor. Equalizing transfers from the center need to continue and be scaled up, but attention has to be paid as well to how equitable the allocation of resources is within provinces, and going one step further down, within counties.

There is a need for additional resources, not just a more equitable allocation of resources

But the challenge of financing the broader poverty reduction agenda is not simply one of redirecting resources from richer to poorer areas. A simple budget-neutral spatial re-allocation of existing resources, even if it were feasible or advisable, would not be adequate to improve the coverage and benefit levels of several programs. Therefore, there is a need as well to devote substantial additional resources to development-oriented poverty reduction, service delivery and social protection. And in doing so, because of existing disparities it will be critical to target all incremental resources to the localities where funding is currently inadequate.

The additional resources could help finance critical expansion and improvements in many key areas of the broader poverty alleviation agenda

What would these additional resources finance? The key areas include:

- further expansion of the rural Di Bao,
- expansion of health insurance to achieve universal coverage of rural and urban populations,
- expanded coverage of rural and urban Medical Assistance schemes,
- expansion of disaster relief and provision of disaster insurance,
- targeted subsidies for high-school education,
- higher benefit levels of rural social assistance and social insurance programs,
- greater subsidization of urban social insurance programs to ensure better coverage of the informal sector,
- scaling up of basic training and job placement services for migrant workers, and improved provision of education and housing services for their families, and
- the development of a unified targeting system.

The scaling up of the poverty reduction initiatives is affordable

While it is difficult to estimate precisely the cost of the expanded initiatives mentioned above, with the total government revenue in 2007 of nearly 5 trillion RMB, the broader poverty reduction agenda is in principle affordable. This is especially so in light of the rapid growth in the combined central and local government revenues at about 20% per year in nominal terms since 2000, significantly faster than the growth in GDP.

The broader poverty reduction agenda is affordable

Very rough estimates of the incremental cost of the key additional initiatives mentioned above suggest an added cost of around 155 billion RMB, which equivalent to 3.1% of the combined tax revenues of central and local governments and 0.6% of the GDP in 2007 (Table 0.4). The scaling up of the poverty reduction efforts along these lines thus certainly seems affordable.

Table 0.4 : A rough estimate of the additional cost of scaling up poverty reduction efforts

Program	Description of additional initiatives	Cost (billion Yuan)
Rural Di Bao	Coverage of an additional 35 million beneficiaries and an average benefit level of 400 yuan per capita for all beneficiaries	17.5
Senior secondary education	Targeted subsidy for 25 million students (equal to the total enrolment in 2006) to cover tuition and miscellaneous fees of 1000 yuan per student	25.0
Rural health insurance	100% coverage of the population with rural hukou and per capita government contribution raised to 100 yuan per capita	71.2
Urban health insurance	100 yuan per capita subsidy to an additional 50 million beneficiaries under the Urban Resident Basic Medical Insurance	5.0
Medical assistance	200 yuan per capita subsidy to an additional 40 million rural and 18 million urban beneficiaries (to bring the total number of beneficiaries in line with expanded coverage of rural Di Bao and current coverage of urban Di Bao)	11.6
Disaster insurance	Per capita subsidy of 33 Yuan (about half the cost of private catastrophic insurance) for 100 million insured	3.3
Support for labor transfer	10 million rural workers at an average cost of 2000 yuan per worker (including 1000 yuan for boarding costs)	20.0
Unified targeting system	Development of a unified targeting system with a registry of 100 million households at the average cost of 10 yuan per household	1.0
Total additional spending for poverty reduction		154.6
As % of total tax revenue (central and local governments in 2007)		3.1
As % of GDP in 2007		0.6

Sources and notes: See main report.

Strengthening institutional arrangements to promote participation, enhance accountability and improve coordination

But an even harder challenge remains, namely to improve governance—capacity, accountability and responsiveness—notably (but not only) at the local level. A concern about channeling larger volumes of central funds to local governments is the lack of adequate financial management systems and monitoring and oversight capacity to ensure that the funds are well-spent.

The government has recognized that local communities can help in effective implementation and targeting of poverty reduction efforts

Experience in other countries suggests that local communities can play an important role in ensuring the effective implementation and targeting of poverty alleviation efforts, and to making programs responsive to the needs of the poor. The Chinese government recognized the importance of this principle when it mandated that the design of poor village investment plans be based on a participatory process. According to official training materials, projects are supposed to be selected by a plenary session of the entire village, with the views of poor households given added weight.

But genuine local participation remains limited, and more needs to be learnt about ways of increasing participation by the poor

However, as discussed in this report, the actual practice rarely adheres to all of the guidelines, and all too often, there was little genuine participation by villagers. The evaluation of the IVDP in this report also found that the better quality of village governance (e.g., village committees with more members, more frequent meetings) enhanced program benefits for both rich and poor in program villages. However, the poorest households did even worse relative to less poor households in villages with highly educated village leaders, a finding consistent with elite capture of program benefits. In light of these findings, high priority should be given to additional study of the village planning process to identify ways to increase participation of the poor, and to experiment with new methods of implementing village plans. There is now considerable international experience with community-based development models, which can provide some lessons for improving village planning and local accountability in China, but an appropriate model for China will also need to consider local institutional and power arrangements in Chinese villages.

The need for inter-agency coordination for the implementation of the broader poverty reduction agenda cannot be overemphasized

Another huge challenge is one of inter-agency coordination. A central theme of this report has been that the China's current poverty reduction agenda is not limited to just the developmental poverty alleviation programs, but also includes pro-poor interventions across a wide range of areas covering education, health, agriculture, migration policies, social assistance and social insurance. This broad spectrum of poverty reduction efforts raises the enormous challenge of institutional coordination across different agencies that are responsible for their implementation.

However, as in the past, coordination among government agencies has proven difficult because each agency has its own priorities and is reluctant to relinquish control over resources. The lack of effective coordination limits the overall effectiveness of the diverse set of poverty reduction initiatives. The symptomatic effects of this are already visible in many forms. For instance:

- The lack of coordination amongst different agencies responsible for developmental poverty alleviation programs has limited the size of village investments, and the diversion of funds to uses that are neither consistent with village plans nor are well-directed to supporting poor households.
- There is a conspicuous absence of a unified targeting mechanism to reach the poor. The area-based programs follow one approach, the social protection programs follow another, not to mention the differences across individual social assistance and social insurance programs themselves.

While the 5-year planning process does provide an overall coordinating framework, there is no effective institutional mechanism to ensure coordination at the implementation level. This gap was highlighted in the case of migration policies, for instance, where in recognition of the multi-sectoral nature of policies related to migrants, in 2006 the government established a Joint Conference on Rural Migrants with representation from Ministries of Labor and Social Security, Civil Affairs, Agriculture, Construction, Education, Health, Justice, Propaganda, Public Security, the National Development Reform Commission, the National Bureau of Statistics, All China Federation of Trade Unions, All China Women's and Youth Federations, the General Bureau of Safety Inspections, and

the Population and Family Planning Commission.

If this was deemed necessary for migration policies alone, the coordination requirements for the wide range of poverty reduction programs and policies (of which those related to migrants are but one part) are much greater still. And these requirements have become even larger with the 11th Five-Year Plan's renewed emphasis and intensification of a broad range of initiatives on social development and the reduction of disparities. Yet, there is absence of an effective body with a large enough mandate and practical authority over other government units to play such a coordinating role. While it is not clear whether any of the existing agencies can be groomed to play this role, establishing an institutional mechanism for inter-agency coordination is critically important to realize the full benefits of the ongoing and future poverty reduction efforts.

Enhancing statistical monitoring and evaluation capacity

China has a well-developed statistical system with substantial capabilities

China has a well-developed statistical system that in many ways exceeds the capabilities of other statistical systems around the world. One example of this capacity is its long-standing tradition of conducting a wide array of annual, large-scale and nationally-representative household and enterprise surveys in the rural and urban areas of the country. It also produces a very large body of statistical information based on non-survey based reporting systems. Most of the analysis presented in this report would have been impossible in the absence of this rich data base.

But there remain some critical gaps in the information base for monitoring and poverty analysis of poverty, including ...

However, the analysis undertaken for this report also highlighted some critical gaps in the information base for the monitoring and policy analysis of poverty and poverty reduction policies and programs. The implementation of the poverty reduction agenda as outlined above will, among other things, also require efforts at enhancing statistical capacity to fill these gaps. The key gaps are in the following areas.

... information on the living and working conditions of migrant population

- One important gap relates to information on migrant population in the national household surveys. China's statistical system has two concurrent annual household surveys conducted independently in rural and urban areas of the country. Starting 2001, NBS' Rural Household Surveys (RHS) began collecting information on individual migrant workers from rural areas who were considered part of their households in the source areas. However, for obvious reasons the RHS is not equipped to gather information on migrants who moved out of the villages with their families. But few of them are picked up by the Urban Household Surveys either whose sample frame is primarily confined to urban residents. Thus, very little information is available on full-family migrants in urban areas, and this alone could potentially lead to some underestimation of urban poverty. More generally, there is a lack of systematic and nationally-representative information on the working and living conditions of migrant population in destination areas that is important for developing future policies in relation to labor mobility. In view of both the large (and growing) scale of migration and its key role in achieving poverty reduction, it will be important to fill this gap.

... information on spatial cost of living differentials

- Another gap relates to information on spatial cost of living differences. In order to have comparable measures of income and consumption across rural and urban areas and across regions and provinces, it is necessary to adjust nominal magnitudes by spatial cost of living indices. While different researchers have attempted to estimate these indices using available price information, and one of the most comprehensive such attempts (Brandt and Holz) has been used for the analysis in this report, the magnitudes of spatial cost of living differentials remains a subject of some debate. As this is critical for a reliable assessment of poverty, greater effort devoted to a regular production of such spatial price differences will be important for both policy analysis of poverty and the monitoring of future progress in poverty reduction.

... information on program participation and utilization of public

- A third important gap relates to information on program participation. As mentioned at a number of points in the report, monitoring and evaluation are key to further reform and refinement of a wide range of initiatives, whether in education or health,

services

development poverty alleviation or social protection programs. While rural and urban household surveys conducted by the NBS have many strengths (e.g. large sample sizes, detailed information on household income and consumption), they have very little information on households' participation in various government programs and their utilization of various public services. This seriously limits the potential of these national surveys for program and policy evaluation. To enhance this potential, the inclusion of one or more additional modules on program participation and service utilization ought to be given a priority in the future development of the main household surveys.

... more detailed information on household characteristics that could be used for proxy-means targeting

- Finally, the idea of a unified targeting system and the potential use of proxy-means targeting has been suggested at a number of places in the foregoing discussion of the current poverty reduction agenda. An implementation of the idea will require data on a range of household characteristics that can serve as proxies for income or consumption as a measure of welfare. Some of these data will be available from the existing household surveys, but more information may need to be collected by augmenting data collection efforts in this regard. Once the means-proxies are identified, it will also be necessary to develop a unified household information registry to implement such a targeting system.