Financial Development and Income Inequality in Rural China 1991–2000

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Introduction

The Chinese economy has experienced impressive growth over the last two decades. However, this rapid growth has been accompanied by remarkable increases in inequality. According to the World Bank (1997), China’s Gini coefficient rose from 0.288 in 1981 to 0.388 in 1995. Similarly, the Chinese official statistics indicate that the Gini coefficient rose from 0.330 in 1980 to 0.458 in 2000 (Chang 2002). More recently, Ravallion and Chen (2007) find that, after adjusting for difference in the cost-of-living between urban and rural China, the Gini coefficient for China as a whole climbed up from 0.280 in 1981 to 0.394 in 2001.

Rising inequality in China has received considerable attention. Earlier attempts mainly focused on the measurement of inequality (Rozelle 1994). Later, efforts were made to decompose overall inequality into within- and between-group components in terms of income, consumption or other social indicators (Tsui 1998; Kanbur and Zhang 1999; Gustafsson and Li 2002). More recently, Wan (2004) and Wan, Lu and Chen (Chapter 1, this volume) explored the contributions of various factors to China’s rising inequality. While these studies provide important insights into the evolving pattern of inequality in China, little research has been conducted to address the role of financial development in the dynamic changes in Chinese income distribution. This chapter attempts to fill this gap by employing the recently released provincial data to explore the relationship between finance and inequality in China.

A growing body of literature on finance and income distribution has shown that financial development can exert important influence on inequality. However, there exist alternative theories that make different predictions concerning the finance–inequality linkage. For instance, in
the dynamic model of Greenwood and Jovanovic (1990), an inverted U-shaped relationship is depicted; that is, financial development could widen income inequality during the early period, then tend to lessen it as average income rises and more households gain access to financial intermediaries and services. By contrast, other theoretical models suggest a negative and linear relationship (for example, Galor and Zeira 1993; Banerjee and Newman 1993), showing that development of financial market and financial intermediation helps reduce income inequality.

Based on a panel data set covering Chinese provinces over the period of 1991–2000, we examine the impact of financial development on income inequality in rural China. The rest of this chapter is organized as follows. The next section provides a brief review on the relationship between finance and income distribution. We then highlight the recent trend of income inequality and financial development in rural China. Empirical analyses are presented and the chapter concludes with a discussion of our findings.

**Financial development and income distribution: a brief literature review**

How does financial development affect income distribution? Two different schools of thought offer quite contrasting answers to this question. The first suggests an inverted U-shaped relationship between finance and inequality. Based on the pioneering work of Greenwood and Jovanovic (1990), two production technologies are assumed: a safe technology with constant but relatively low returns to investment, and a risky technology with expected high returns; further assuming that entry into the financial market is costly at a fixed price. Due to this entry fee, access to the financial sector may be restricted to agents with an amount of wealth above a certain threshold level. Their model shows that the development of financial intermediaries helps overcome the information friction on risky investment through collecting and analyzing information on investment projects. It also contributes to smoothing away idiosyncratic shock through risk diversification, trading and pooling.

Therefore, Greenwood and Jovanovic (1990) predict that, along with the financial intermediary development, the evolution of income inequality follows an inverted U-shaped path: in the early stage of development when financial intermediaries are less developed, the economy grows slowly with low inequality; in the intermediate stage of development, widening income inequality coincides with more rapid economic growth and further deepening financial development; by maturity, when...