

Growth Pattern, Employment, and Income Inequality: What the Experience of Republic of Korea and Taipei, China Reveals to the People's Republic of China

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The People's Republic of China (PRC) achieved rapid economic growth during the last 30 years, but its income distribution has worsened. In contrast, Republic of Korea and Taipei, China experienced high growth for several decades after the 1950s, while managing to keep income inequality low. This paper looks at development experiences of Republic of Korea and Taipei, China in the 1950s–1990s, and concludes that the key to achieving high growth with low inequality in the two economies was the adoption of a growth strategy that promoted development of labor-intensive industries and small- and medium-size enterprises. The creation of large amounts of employment opportunities to absorb rural surplus labor and reduce urban unemployment played a key role in keeping income inequality low. The paper argues that to reduce income inequality in the PRC, the government should shift to a more labor-intensive development strategy, encourage the development of small and medium enterprises, and unify the labor market.

I. INTRODUCTION

Many countries have pursued growth as the ultimate objective of economic development. The People's Republic of China (PRC) has done the same, hoping that a sufficiently high growth rate will ensure a strong nation and provide the population enough food and shelter to lead a comfortable life. The shift to market-oriented policies and reform initiatives that the PRC has taken since the late 1970s focused on ways to achieve this high growth rate. Thus far, the PRC has been quite successful. Between 1979 and 2005, the country's per capita gross domestic product (GDP) increased at an annual rate of 8.4 percent. The per capita income for urban and rural households increased at annual rates of 6.9 and 7.0 percent, respectively (NBSC 2006a). The incidence of poverty fell dramatically: between 1978 and 2005, the number of rural poor dropped from 250 million to 23.65 million, while the rural poverty rate fell from 31 to 2.5 percent (NBSC 2006b).

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The PRC's economic reform program began when the economy was largely egalitarian but had serious inefficiencies. Over time, better incentives helped increase economic efficiency and accelerate economic growth. However, income inequality has increased significantly. In the late 1970s, the World Bank estimated the Gini coefficient in the urban and rural areas of the PRC at 0.16 and 0.31, respectively, and the national Gini coefficient at 0.33 (Zhao and Li 1999). The national Gini coefficient rose to 0.45 in 2002 (Li and Yue 2004). By 2005, the Gini coefficient in the PRC's urban and rural areas rose to 0.34 and 0.38, respectively (NBSC 2006c). The increases in inequality among urban households and widening urban-rural income gaps have been the key drivers of rising inequality.

Policymakers have increasingly become aware of the negative economic and social consequences of rising inequality. However, opinions differ in government and academic circles. Some analysts view the rising inequality as a trade-off with rapid economic growth, and expect that inequality will eventually decline at a certain point as predicted by Kuznets's (1955) "inverted-U curve hypothesis." Others are more concerned. Notably, since the mid-1990s, the PRC's share of wage incomes in GDP has fallen steadily (Figure 1), whereas the share of capital incomes has continued to rise, suggesting that increases in inequality have occurred largely in the stage of income generation.

Figure 1. Shares of Wage Incomes and Consumption in GDP in the PRC (percent)



GDP = gross domestic product; PRC = People's Republic of China.
Source: World Bank (2007).

Unlike the PRC, some of its East Asian neighbors—Japan; Republic of Korea (henceforth Korea); and Taipei,China—have experienced high economic growth while keeping inequality low. This paper seeks to understand the development experiences particularly of Korea and Taipei,China. A corollary

objective is to glean from these experiences the lessons that are most applicable for the PRC to help sustain a rapid but more equitable growth.

II. GROWTH AND INCOME DISTRIBUTION: THEORETICAL DISCUSSIONS

In his inverted-U hypothesis, Kuznets (1955) argued that at the initial stages of economic development, as per capita income rises, inequality may increase as a result of the shift of labor from the agricultural to industrial sectors where wages are much higher. Inequality will reach a maximum at an intermediate level of income, and then decline as income levels characteristic of an industrialized country are reached. This hypothesis, however, ignores the possibility of the existence of surplus labor and unemployment when income levels are low. What would happen to income inequality if surplus labor and unemployment are taken into consideration?

This takes us to Lewis's two sector model of the dual economy (Lewis 1954). In the Lewis model, there exists a large amount of surplus labor in the traditional agriculture sector, providing unlimited supply of labor to the modern industrial sector. With labor supply exceeding demand, the industrial wage rate is kept at the minimum subsistence level. In this model, therefore, the wage rates for agriculture and industry are almost the same, and income gaps between workers are small. The major source of income inequality is capital returns.

The Lewis model does not elaborate on how income distribution evolves in the process of industrialization. The labor force may be grouped into three categories: those employed in industry, those employed in agriculture, and the unemployed or semi-employed. Even if the agricultural wage rate is assumed to be equal to the industrial wage rate, as in the Lewis model, there would be income differentials between employed and surplus labor. If Kuznets' assumption is valid that the industrial wage rate is higher than the agricultural wage rate, then there would also be income differentials between industrial and agricultural labor. In other words, whether we introduce the assumption of unlimited labor supply of the Lewis model into Kuznets' inverted-U hypothesis, or introduce the assumption of the industrial wage rate being higher than the agricultural wage rate into the Lewis model, the result is the same: income inequality will increase at the initial stage of economic development.

The foregoing modifications of the Kuznets hypothesis and Lewis model, making them better fit the reality in the PRC, are necessary if they are used to explain the relationship between economic development and inequality in the PRC, but do not go far enough. This is because, whether in the prereform or postreform periods, the PRC economy does not satisfy many of the neoclassical economics assumptions as implied in the Lewis model. For example, the labor market in the PRC is seriously segmented. When rural laborers were not allowed

to migrate to urban areas, the wage rate in the urban industrial sector was set by the government, and did not have any link with the wage rate in the agricultural sector. When rural laborers were later allowed to migrate, there were still many restrictions, leading to a dual labor market in the urban areas—the labor market for local urban workers, with the wage rate set by governments, and that for rural migrant workers, with the wage rate determined by demand and supply. Only the wage rate for migrant workers is somewhat linked to the wage rate in the agricultural sector.

In addition, the PRC labor market is segmented into formal and informal ones and, even in the formal sector (government offices, public institutions, and medium- and large-size enterprises), wage rates and welfare entitlements differ depending on whether a worker has permanent local residency and whether the employment is permanent or temporary. The existence of a dual labor market with the formal and informal sectors may be a common phenomenon in developing countries, but the differentiation of workers with a formal residency status from those without is unique to the labor market in the PRC.

In such a situation, at the initial stage of economic development, the pace of increase in income inequality would be faster than that described in the Kuznets model. This is because income differentials exist not only between the employed and unemployed or underemployed, but also between laborers employed in the agricultural sector and those in the industrial sector, between workers with different statuses in the urban industrial sector, and between skilled and unskilled workers.

It can be argued that with the coexistence of various types of income differentials, the evolution of overall income inequality will depend on the choice of the pattern of economic growth—whether it is labor-intensive or capital-intensive. Compared with a growth pattern that is more capital-intensive, a labor-intensive growth pattern will create more job opportunities, leading to lower unemployment; faster reduction in surplus labor; and earlier arrival of the so-called “Lewis turning-point”, a point where labor demand and supply are equalized.

The implication of this for income distribution is obvious. When there is no unemployment, there will be no income differentials between employed and unemployed workers; when there is no surplus labor, income differentials between people employed in the agricultural sector and in other sectors will also be low and eventually vanish. Furthermore, greater demand for labor, including unskilled labor, will push up the wage rate, making it grow faster than otherwise under a capital-intensive growth pattern. The faster growth of the wage rate will help narrow the income differentials between urban formal sector workers and migrant farmer laborers, and between the skilled and unskilled. This will increase the share of wage incomes in GDP, further reducing income inequality.

III. EXPERIENCES OF KOREA AND TAIPEI, CHINA DURING THE 1950s–1990s

After World War II, several Asian economies, particularly Japan; Korea; and Taipei, China, achieved rapid economic growth while keeping income inequality low. This was lauded in the development literature as a “miracle” (World Bank 1993) and new model of Asian economic development (Kuznets 1988). Of these countries, Japan was the frontrunner and the first Asian country to join the ranks of developed nations. Hong Kong, China; Korea; Singapore; and Taipei, China followed closely as their economies took off in the 1960s. In the early 1960s, Japan completed its structural transformation after achieving the “Lewis turning point.” This point was similarly achieved by Taipei, China in the early 1970s, and by Korea in the late 1970s (Minami 1968, Kuznets 1988).

Although Korea and Taipei, China are currently at the same stage of development, they differ in their development strategies. Taipei, China focused on developing small- and medium-size enterprises (SMEs) and generating jobs that helped equalize incomes at an early stage of development. In contrast, Korea had a relatively less equal income distribution in its earlier stage of development as it initially focused on promoting large-scale enterprises that supported rapid growth but failed to create large amounts of jobs, leading to higher unemployment and widening income gaps. After the mid-1970s, however, the income gap in Korea declined significantly as the country paid greater attention to creating jobs and developing SMEs.

A. Income Distribution

Taipei, China’s high growth phase began with land reforms in the early 1950s. For Korea, the economic boom started with the first 5-year development plan in 1962. While the average growth of 23 East Asian economies during 1965–1990 was the highest in the world (World Bank 1993), the growth rate of Korea and Taipei, China was double (Table 1). More importantly, during the industrialization process, income distribution in the two economies did not follow the Kuznets inverted-U curve. On the contrary, they managed to keep income inequality low—and even declining at some points—except during the early to middle part of the 1970s in Korea.

Table 1. **Growth in Gross Domestic Product in Republic of Korea and Taipei,China**
(percent)

Republic of Korea		Taipei,China	
Period	Growth Rate	Period	Growth Rate
1961–1962	4.0	1952–1962	7.9
1963–1969	10.1	1963–1979	10.0
1970–1979	9.3		
1980–1989	8.2	1980–1989	8.5
1990–1995	7.5	1990–1995	7.9

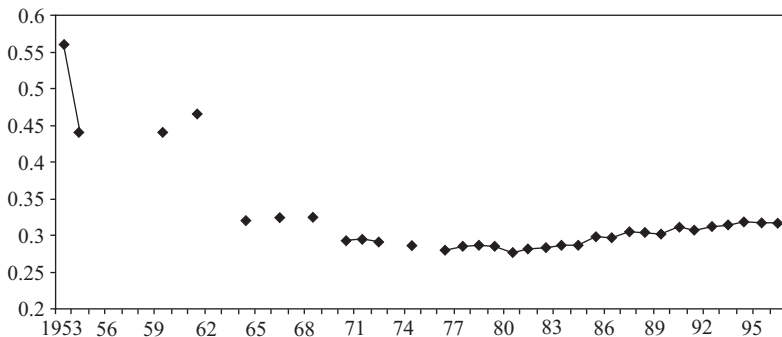
Sources: CEPD (2006), An (2004).

In the 1950s and 1960s, the income gap in Taipei,China narrowed considerably, and remained stable for a long time (Bourguignon et al. 2001). In the late 1970s, the income gap began to widen but stayed low. Until 1995, the income Gini coefficient remained below 0.32 (Figure 2). The highest Gini coefficient was 0.35 in 2001.

Korea’s income distribution fluctuated in the 1960s. Later in the decade, the income gap began to widen and continued to do so until the mid-1970s, with the Gini coefficient reaching its highest level at 0.39 in 1976 (Figure 3). The Gini coefficient has, however, since dropped, by nearly 20 percent in 1996 from its peak in 1976, to the level it was before the economic take-off.

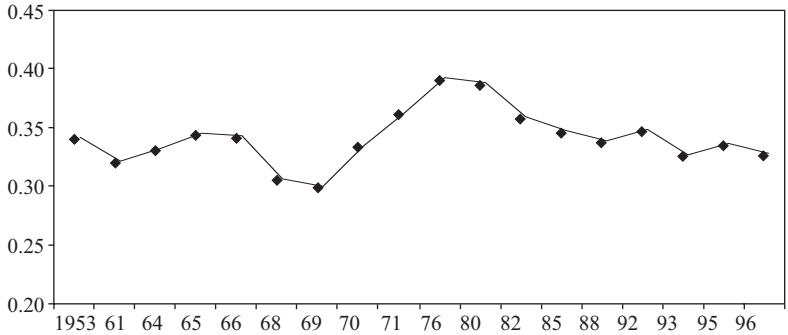
Interestingly, the trend in the urban–rural income gap in Korea was somewhat different from that of the national inequality (Figure 4). The urban–rural income gap widened sharply in the early 1960s, with the ratio of urban to rural incomes reaching 1.7:1. This is common in developing countries at the early stage of an economic take-off. By the 1970s, the national income disparity had widened but the urban–rural income gap decreased in line with the Kuznets hypothesis. This resulted from the migration of rural labor to the cities.

Figure 2. **Gini Coefficients in Taipei,China**



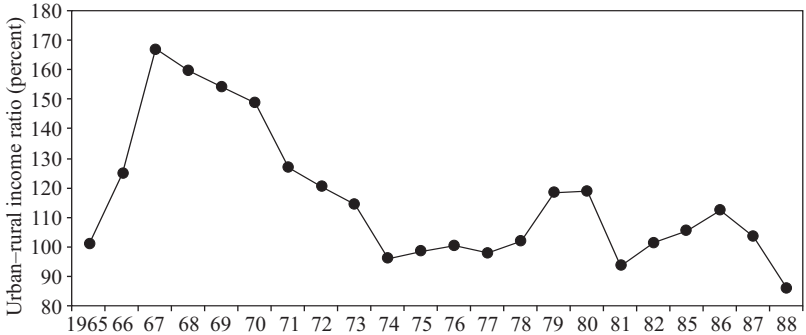
Sources: Deng (2005); Li, Zhang, and Wang (1998); CEPD (2006).

Figure 3. Gini Coefficients in Republic of Korea



Source: UNU-WIDER (2007).

Figure 4. Urban-Rural Income Gap in Republic of Korea



Source: Zhou (2006).

The experiences of Korea and Taipei,China show that rising income inequality is not unavoidable during high-growth periods, and there is no inherent relationship between the stages of economic development and income inequality. To a large extent, the level of income gap depends on the choice of the pattern of growth.

B. Economic Structure

This section analyzes the growth patterns in Korea and Taipei,China and explores how these led to declines in income inequality. Economic growth in both economies was characterized by significant changes in the economic structure. First, changes occurred in terms of the sectoral structure, with the share of agriculture in GDP falling, the share of tertiary industry rising, and the share of secondary industry fluctuating. Second, both economies became more export-oriented.

Changes in the economic structure in Korea and Taipei,China can be examined by studying them in two phases, i.e., before and after 1980 (Table 2 and Figure 5). Before the early 1980s, the decline in agriculture's share in GDP coincided with the rise in industry's share, while the contribution made by services remained relatively steady.

Moreover, during this period, industry—particularly manufacturing—grew rapidly in response to the fast growth in foreign trade. Limited by the domestic market, manufacturing shifted to producing for exports. Taipei,China's reliance on foreign trade increased from 26.7 percent of GDP in 1960 to 95.4 percent in 1980 (Table 2). After the 1980s, as the manufacturing sector's share in GDP fell and the share of services rose, Taipei,China's reliance on foreign trade declined and stabilized in the 1990s. In Korea, foreign trade stood at about 60 percent of GDP in 1990.

From the early 1980s onward, the importance of the agricultural sector in the economy continued to fall in Korea and Taipei,China (Figure 5). By 1990, agriculture's share in GDP dropped to 8 percent in Korea and 3 percent in Taipei,China. Meanwhile, industry's contribution to GDP in both economies also began to weaken. This was most evident in Taipei,China between 1980 and 1995, when the share of industry in GDP dropped by 11 percentage points (Table 2). This period also saw robust growth in services, with its share in GDP growing significantly by 16 percentage points. In Korea, industry's share in GDP did not decline, but that of the service sector rose by 5 percentage points between 1980 and 1990.

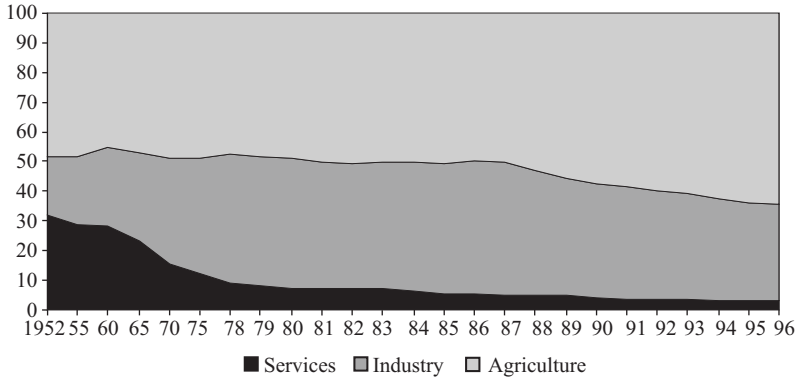
Table 2. Changes in Economic Structure in Republic of Korea and Taipei,China (percent)

Economy and Sector	1960	1970	1980	1990	1995
Republic of Korea					
Share in GDP					
Agriculture	39.9	31.1	14.6	8	
Industry	18.6	28.4	41.4	43	
Manufacturing	12.1	19.1	29.6	29	
Service	41.5	40.5	44	49	
Export/GDP				28.8	
Import/GDP				29.9	
(Export + Import)/GDP				58.7	
Taipei,China					
Share in GDP					
Agriculture	28	15	8	4	3
Industry	27	37	46	41	35
Manufacturing	19	29	36	33	28
Service	45	48	46	55	62
Export/GDP	9.3	27.9	47.8	42.0	43.0
Import/GDP	17.4	26.8	47.6	34.2	40.3
(Export + Import)/GDP	26.7	52.7	95.4	76.2	83.3

GDP = gross domestic product.

Sources: An (2004), Harvie and Lee (2003).

Figure 5. Sectoral Composition of GDP in Taipei,China (percent)



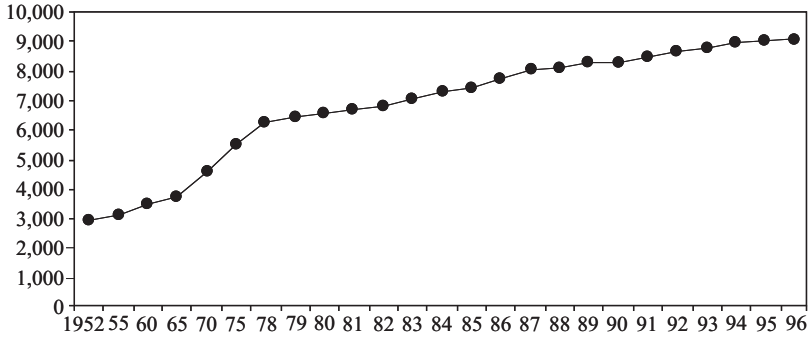
GDP = gross domestic product.
 Source: CEPD (2006).

C. Employment Growth and Structure

Amid significant changes in the economic structure, the level of employment rose steadily in both Korea and Taipei,China as the two economies grew rapidly. In the case of Taipei,China, the rise in employment can be divided into two stages, the first being a period of rapid growth and the second one of steady expansion. As Figure 6 shows, between 1965 and 1978 the number of employed people rose from 3.7 million to 6.2 million (or about 192,000 annually), with an annual average growth rate of 4.1 percent. The unemployment rate dropped from 4 percent or so in 1960 to less than 1.3 percent in 1980 (Figure 7).

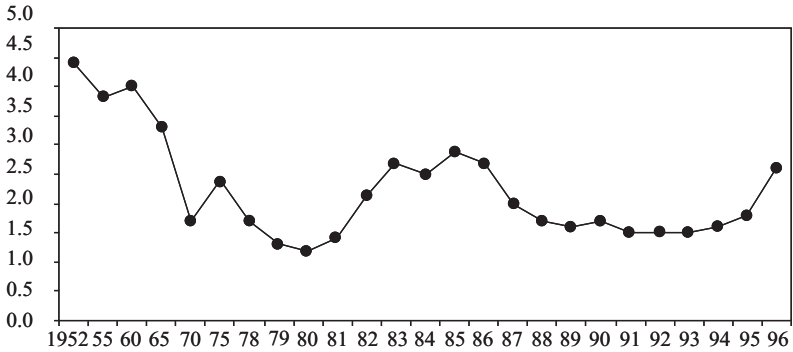
During the second stage, employment continued to rise in Taipei,China, although at a slower pace. Between 1980 and 1995, the number of employed people rose from 6.5 million to 9 million (or about 166,000 annually), with an annual average growth rate of 2.2 percent. The unemployment rate rose from 1.3 percent in 1980 to 3 percent or so in 1985.

Figure 6. **Employment in Taipei,China**
(Unit: 1,000 workers)



Source: CEPD (2006).

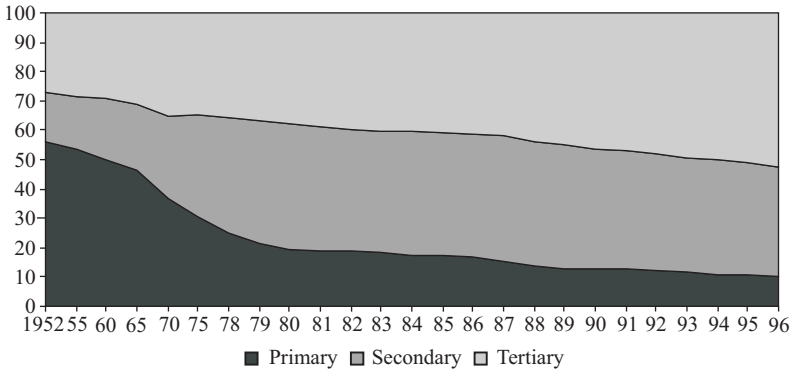
Figure 7. **Unemployment Rate in Taipei,China**
(percent)



Source: CEPD (2006).

The two stages of employment growth in Taipei,China correspond to the two stages of change in the economic structure. Rapid growth in manufacturing was accompanied by a commensurate increase in employment. As services replaced manufacturing to become the new driving force of the economy, employment grew steadily but at a slower pace. Between 1965 and 1980, the number of people employed in the primary industry (dominated by agriculture) decreased rapidly while those employed in the secondary industry (dominated by manufacturing) increased rapidly (Figure 8). After 1980, growth in employment came mainly from the tertiary industry.

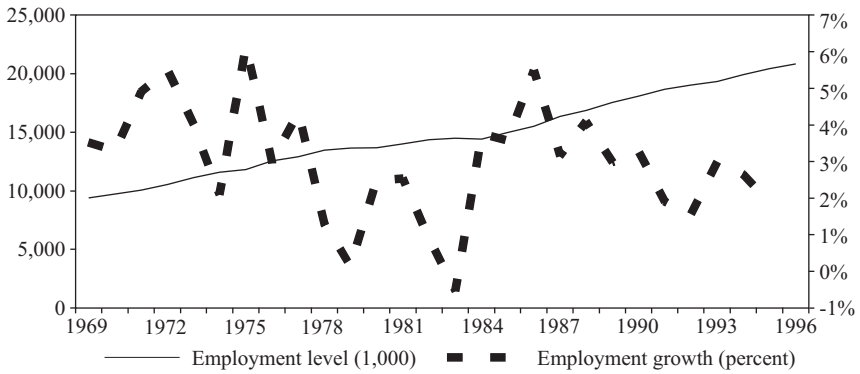
Figure 8. Employment Structure in Taipei,China (percent)



Source: CEPD (2006).

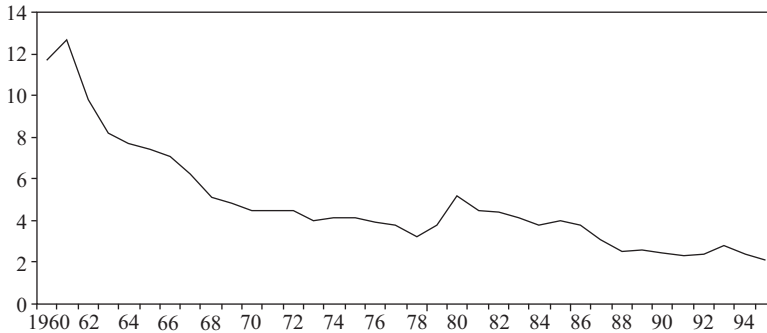
In Korea, employment grew rapidly before the late 1970s (Figure 9), coinciding with a period of fast growth in the manufacturing industry. The unemployment rate dropped from 12 percent in 1960 to less than 4 percent in 1980 (Figure 10). However, between the late 1970s and mid-1980s, employment growth in Korea slowed for several years, and even declined in some years. This period was also marked by high unemployment and high inequality.

Figure 9. Trend of Employment Growth in Republic of Korea



Source: ILO LABORSTA website (ILO 2007).

Figure 10. Unemployment Rates in Republic of Korea
(percent)



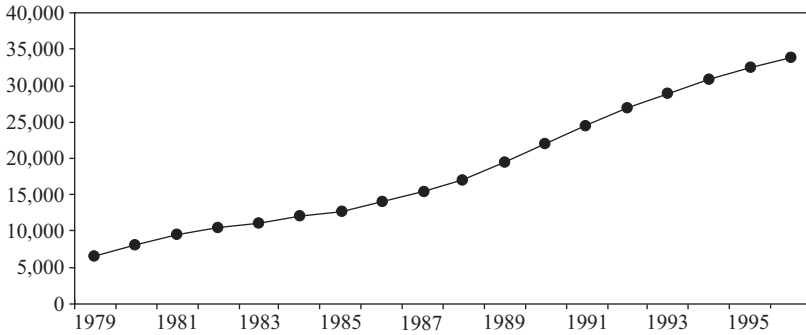
Source: ILO LABORSTA website (ILO 2007).

The foregoing experiences (changes in economic structures, in employment growth and structures, and in unemployment) of Korea and Taipei, China illustrate how economic growth can affect the distribution of incomes at various stages of development. Before the 1980s, Taipei, China's economy shifted from agriculture to industry. Rapid growth in employment narrowed the income gap as evidenced by the decline in the Gini coefficient from 0.33 in the early 1960s to 0.27 in 1980 (Figure 2). After the 1980s, the share of manufacturing in GDP was relatively steady; the rate of employment growth slowed; and unemployment rose. This was certainly linked to the widening income gap that took place at the same time.

Korea's economic development progressed similarly. Before the late 1970s, rapid growth in employment kept the income gap relatively stable. In the few years that ensued, employment growth slackened and the unemployment rate began to rise. This led to a widening income gap.

Undoubtedly, the rapid development of the manufacturing sector and the sharp rise in employment played an important role in reducing the income gap in both economies. In particular, high wages in the manufacturing sector helped reduce income disparities. In Taipei, China, the per capita monthly wages in the manufacturing sector rose steadily between the early 1980s and the mid-1990s (Figure 11). Between 1979 and 1996, the per capita monthly wages in manufacturing rose nearly 4.2 times, with an annual average growth rate of about 10 percent (CEPD 2006).

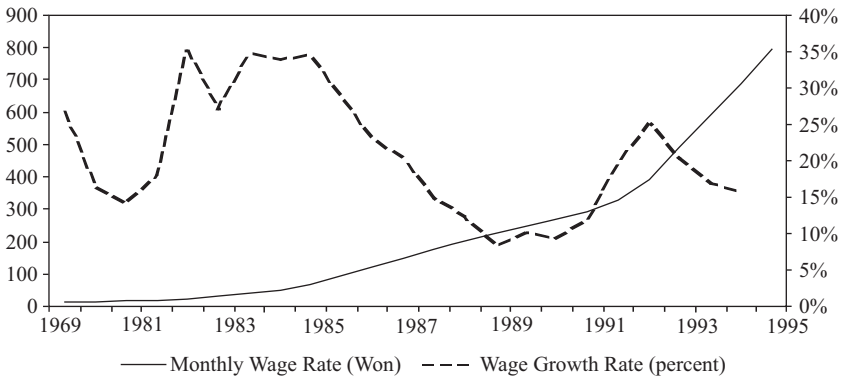
Figure 11. Monthly Wage Rates in Taipei, China's Manufacturing Sector (T\$/month)



Source: CEPD (2006).

Similarly, in Korea, manufacturing wages remained high between 1969 and 1991. Throughout the 1970s, manufacturing wages grew by 15 percent or more each year, and in some years, they rose by as much as 30 percent (Figure 12). According to some studies (An 2004), the Government of Korea intervened in the labor market in the early years of the economic boom and the employees' bargaining power on wages and/or welfare entitlements was suppressed by the government. As a result, the growth rate of nominal wages was below the growth rate of productivity. When the market became more liberalized in the late 1980s, the wage rate grew faster than that of productivity.

Figure 12. Monthly Wage and Growth Rates in Republic of Korea's Manufacturing Sector



Source: ILO LABORSTA website (ILO 2007).

The rapid growth of wage rates in the labor-intensive manufacturing sector caused the proportion of wage incomes in national income to rise, from 40

percent in 1960 to 55 percent in 1995 in Taipei,China; and from 37 to 61.2 percent during the same period in Korea (Table 3).

In summary, the changes in the economic structure and ensuing increase in employment in Korea and Taipei,China ensured that people had the opportunity to share the outcomes of growth. The two economies chose a unique growth strategy to avoid widening the income gap, a problem commonly encountered by developing countries at the early stages of economic development. This growth strategy was deployed in two stages. During the first stage, both economies vigorously promoted the development of labor-intensive industries, especially manufacturing, to absorb surplus labor from agriculture in large numbers, thereby reducing unemployment. Consequently, the share of wage incomes in national income rose. During the second stage, the growth of the services sector replaced manufacturing growth. Because there was no surplus labor left, growth fuelled a rise in manufacturing wages that helped limit wage differentials between industries, and prevented the income gap from widening.

Table 3. **Employees' Wage Income as a Share of National Income** (percent)

	1960	1965	1970	1975	1980	1985	1990	1995
Taipei,China	39.9	42.0	44.6	49.1	50.3	53.8	55.3	54.9
Republic of Korea	37.4	31.8	41.4	40.6	52.1	53.9	59.0	61.2

Sources: CEPD (2006), Bank of Korea (various years).

D. Small and Medium Enterprises and the Growth of Employment

Being the driving force of Taipei,China's export-oriented economy, SMEs played a key role in its economic development. A large number of SMEs helped ensure that markets are competitive. More importantly, the labor-intensive production technology that SMEs adopted helped generate large amounts of employment opportunities. In the manufacturing sector, an enterprise on average employs 27 workers, and most factories only employ 10 or less workers (Chen 2006). In 1971, Taipei,China had 44,054 enterprises in the manufacturing industry, 68 percent of which were small-size enterprises that employed 20 or fewer workers, and 23 percent were medium-size enterprises that employed more than 50 workers (An 2004). These SMEs not only created numerous job opportunities, but also helped narrow the urban-rural income gap.

In the late 1950s, Korea had a limited number of SMEs, with only 0.5 enterprises per 1,000 people in 1958. Korea began to develop SMEs actively only in the late 1970s. By 2004, it had 2.8 million SMEs, nearly 58 enterprises per 1,000 people (T. Zhou 2006). Some studies show that in 2002, SMEs accounted for 99.8 percent of the total number of enterprises, and contributed 42.2 percent of total exports (Huang et al. 2005).

During the last several decades, Korea and Taipei,China adopted specific policies and measures to promote the development of SMEs. Taipei,China started the SME promotion policy in the 1960s; the policy gradually evolved into a set of supportive measures known as the “supervision plan” for SMEs. Between the late 1980s and mid-1990s, the authorities at all levels established a special agency to support SMEs (Long 2002). In 1990, the Regulations for the Development of Small- and Medium-sized Enterprises were adopted. The regulations mandated the Ministry of Economy and authorities at all levels to be supervising agencies of SMEs; required setting up an SME development fund to improve access to credit by SMEs; required the authorities at all levels to set up or assist the private sector to set up service centers to provide advisory services to SMEs on business management, marketing, and product development; and provided tax reduction or exemptions for SMEs (Hong 1999, Long 2002).

In Korea, various measures were also introduced by the government to promote SME development. Measures to support newly established enterprises include simplifying requirements for starting a new business; providing starter funds; introducing tax reduction or exemptions at the start-up stage; and providing advice on marketing plans and business feasibility (Wang and Zhong 2001). To ensure fair competition, the government amended the financial law, fair trade law, and commercial law to create an even playing field for SMEs as for large enterprises. The government also spent large amounts of resources on promoting technical exchanges between SMEs and large enterprises (Ma 2000).

To provide financial support for SMEs, Korea established three funds: the credit guarantee fund, used to guarantee loans to SMEs; the business starter fund, for improving technical prowess and for promoting structural adjustment of SMEs; and the mutual aid fund, for preventing enterprises from falling into debt and bankruptcy (Wang and Zhong 2001). It also enacted the Special Banking Law, which holds the SME banks and the National Bank responsible for SMEs’ financial transactions. The Law also requires several large banks to ensure that a certain proportion of their loans be provided to SMEs.

The Government of Korea also took various measures to reduce the risks faced by SMEs. After the Asian financial crisis, the government assigned more than 40,000 industrial technicians to nearly 10,000 SMEs to help with labor shortages, and set up a fund to address unemployment. The government also promulgated the Law for Procurement Promotion to support SME development and promote the marketing of their products, by specifically requesting government departments to buy SME products. It set up export support centers that provide SMEs with information on export markets and assist them in obtaining ISO certification (Ma 2000).

E. The Financial System: Supporting a Labor-Intensive Growth Strategy

Taipei, China did not experience a widening income gap despite rapid growth. In Korea, things were somewhat different, with a widening income gap at the early stage of the economic take-off. But because Korea turned to the expansion of employment as an important goal since the late 1970s, it quickly reversed this trend, passed the “Lewis turning point”, and managed to achieve rapid growth while keeping inequality low. A key to this success is the adoption of a labor-intensive growth strategy characterized by rapid development of SMEs. Promoting employment creation requires not only pro-active government policies, but also a financial system conducive to SME development.

First, it is critical to develop a financial system that supports the development of SMEs. Among the measures undertaken, Korea established a policy-based fund to provide loans to qualified enterprises through specialized banks. An SME new business fund provides special loans to SMEs that employ new technologies and have export potential (Wen 2005). In Taipei, China, financial support for SMEs includes financing, guarantees, and production expansion (Zhu and Liu 2001). Financing is also made available by ordinary commercial banks. Some government-run savings companies were regrouped into professional banks that provide loans for SMEs.

Second, it is important to liberalize the financial markets and provide space for small- and medium-size financial institutions to develop. The experiences of Korea and Taipei, China show that, in addition to the government, which provides policy loans to SMEs through commercial banks, most lenders to SMEs are small and medium-size financial institutions. To promote the development of these financial institutions, the financial market needs to be improved and the government needs to provide support and assistance in this regard.

IV. LESSONS FOR THE PRC

While the economy has grown rapidly, income distribution has also worsened in the PRC. Some studies predict that the PRC will likely reach its “Lewis turning point” in the near future. However, whether this will lead to a narrowing in the income gap remains uncertain because the mechanism of income distribution in the PRC is partly regulated by the market and partly guided by the government. In addition, given the serious segmentation in the labor market and the social security system, further worsening in income distribution is still a possibility.

The development of many economies is marked by a transition from the traditional to the modern economy. This normally progresses in two stages: (i) a process of industrialization whereby there is a shift of labor from agriculture to industry; and (ii) a transition from a labor-intensive economy to one that is capital- and technology-intensive, referred to as a process of capital

intensification. Taipei, China underwent its first stage in the 1960s and the mid-1970s, and started the second in the late 1970s and the 1980s (Huang 2005). Korea's first stage took place 5–10 years later than in Taipei, China. Because the Government of Korea initially relied too much on large enterprises, the transition process took longer (T. Zhou 2006), with the second stage beginning in the 1990s, characterized by the rising importance of the tertiary industry in generating income and employment.

In contrast with both these economies, the PRC is still in its first stage of transition, which may be completed in 5–10 years. It appears that the PRC is taking much longer to complete this stage of transition than Korea and Taipei, China did. Part of the reason for this is that the policymakers and the academic circle have not paid adequate attention to the economic and social implications of this stage of transition; rather, related policies have focused too much on promoting the second stage of transition that is still premature for the PRC (Lin and Liu 2008).

The foregoing discussions on growth patterns and income distribution in Korea and Taipei, China suggest that the key to achieving high economic growth while keeping income inequality low is the adoption of a labor-intensive growth strategy conducive to creating employment opportunities and eliminating surplus labor in rural areas. The PRC can draw important lessons from these experiences.

- (i) The PRC should focus more on employment creation when choosing its growth strategy. In the past 20 years, industrial development in rural areas and the migration of rural labor to urban areas have reduced rural surplus labor. However, the scale of existing rural surplus labor remains significant. Moreover, a large number of urban workers remain laid-off and unemployed. Therefore, developing labor-intensive industries to absorb remaining rural surplus labor and unemployed urban workers should be at the top of the development agenda for the PRC. As shown by the experiences of Korea and Taipei, China, reduction in rural surplus labor and urban unemployment helps reduce income inequality.
- (ii) The shift from a capital-intensive to a more labor-intensive growth pattern requires reducing monopolistic practices and developing SMEs. Despite the fact that the PRC's income level is lower than that of Korea and Taipei, China, its SMEs play a far less important role in generating employment than in the two economies. In other words, the share of employment by PRC's large enterprises exceeds what is normally associated with its income level.
- (iii) To promote the development of labor-intensive industries and SMEs, it is essential to reform the existing investment system, by reducing government involvement in the economy at all levels and increasing

private investment. The experiences of Korea and Taipei, China show that relying on public sector investment to develop SMEs is not feasible. In many areas, the PRC should eliminate various obstacles that prevent entry by SMEs and allow them to compete with others on an equal footing.

- (iv) Promoting SME development also requires the development of appropriate financial and fiscal systems. Currently, in the PRC, the financial system mainly serves large enterprises, particularly the big state-owned enterprises. There is a lack of small banks that cater to SMEs. Thus, developing small- and medium-size financial institutions should also be part of the SME development strategy. Furthermore, the existing collateral requirements constitute significant barriers for SMEs to obtain bank loans. There is a need to apply a collateral system for SMEs that is different (and less restrictive) than that for large enterprises. The banking system should be made more responsive to the needs of the SMEs, and tax benefits should also be given to them.
- (v) Most importantly, it is essential to develop a unified labor market and eliminate all kinds of institutional factors that obstruct labor and capital from flowing freely.

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