

IDS Bulletin

Transforming Development Knowledge

Volume 52 | Number 2 | November 2021

CHINA AND INTERNATIONAL DEVELOPMENT: KNOWLEDGE, GOVERNANCE, AND PRACTICE

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Exploring China's Impacts on Development Thinking and Policies^{*†}

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Abstract In this article, we explore the impacts, actual and potential, of China's development experiences upon development thinking and policies elsewhere. New Structural Economics, a theoretical innovation by Professor Justin Yifu Lin drawing on a longer tradition of pragmatic 'learning by doing' development strategies, provides a framework in which three agendas stand out: structural transformation as a policy priority; the return of industrial policy; and the use of Special Economic Zones. We integrate related drivers of growth in China: rapid urbanisation pulling in massive rural migration in an economic transformation process; the financing of provincial and city governments by improvised local government financing vehicles based on rising urban land values; and competition and accountability processes in China's subnational governance system. While China's experiences cannot be directly replicated elsewhere, we argue that lessons on why and how to achieve structural transformation are relevant for other developing countries, especially in fast urbanising and integrating Africa.

Keywords New Structural Economics, development thinking, international development, industrial policy, Special Economic Zones, structural transformation, effective markets, facilitating government.

1 Introduction

Over the past four decades, China has achieved unprecedented economic development and poverty alleviation. Its example has made a deep impression, raising the question of what the lessons are for development thinking and practice. Once the richest country in the world (Maddison 2001), China had become entrapped in poverty for several centuries. Its gross domestic product (GDP) per capita was US\$156 in 1978, less than one third of the average of US\$490 in sub-Saharan African countries. But since the transition from planned to market economy in the late

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The *IDS Bulletin* is published by Institute of Development Studies, Library Road, Brighton BN1 9RE, UK
This article is part of *IDS Bulletin* Vol. 52 No. 2 November 2021 '**China and International Development: Knowledge, Governance, and Practice**'; the Introduction is also recommended reading.



1970s, China has eradicated extreme poverty and overtaken the United States as the world's largest economy measured in purchasing power parity (PPP) in 2014.³

'Economic miracles' such as those in China and other Asian countries have been explained by Robert Lucas as the combination of rapid urbanisation with fast human capital development, including notably learning by doing via trade (Lucas 1988, 1993; Glaeser and Lu 2018). China's reform programme did not involve disruptive 'shock therapy'. Chinese economists debated but then avoided the mainstream neoliberal programme of privatising its state-owned enterprises, liberalising its trade and capital accounts, and deregulating its economy in a sweeping manner.

Instead, China adopted a pragmatic dual-track approach to the liberalisation of markets. Starting with the rural economy, the government first improved incentives and productivity by replicating across the country the household responsibility contracting system. This allowed workers in collective farms and state-owned firms to be residual claimants, setting their own selling prices at the market after delivering quota obligations to the state at fixed prices. At the same time, the government continued to provide support to non-viable firms in priority sectors to avoid the collapse of social cohesion and human capital (Lin 1992).

From this beginning, China progressively moved to a market system using the dual-track price system approach which quickly generated a flourishing rural economy with town and village enterprises while retaining priority sectors in state hands (Weber 2021). At the same time, there was major decentralisation to provinces and cities, counties and townships, where meritocratically selected governors and mayors became responsible for economic performance and social stability, and were accountable to the central authorities on both fronts, in a form of 'franchise' from central to subnational levels.

This system helped to spread talent and initiative around the entire large and varied territory of China, even if coastal regions grew faster than inland areas and the west of China (Xu 2011). The dynamics of this 'matrix' governance system remain driving factors in China's performance today. This explains how, with its many levels of initiative, development could proceed so rapidly, and villages become large modern cities (Xiao *et al.* 2015). According to Ang (2016), the development of governance and markets is not sequential but 'co-evolutionary'. The process operates as follows: weak institutions are used to generate markets, emerging markets stimulate strong institutions, and then strong institutions preserve markets. Such co-evolutionary processes can be observed elsewhere, historically and geographically, and are thus an inherently generic pathway from low development capacities to strong development capacities.

The generic elements of China's experience can thus offer an alternative to mainstream prescriptions for institutional and market development. We look at three such generic lessons from Chinese development history of the last four decades. First, structural transformation matters for large-scale poverty alleviation. Second, a facilitating government can aid market development. Last, but not least, to kick start structural transformation, Special Economic Zones (SEZs) can be used to overcome the challenge of poor institutional capacities nationwide by improving the business environment in demarcated areas to achieve quick wins.

In this article, we aim to explore the extent to which China offers alternative development thinking and policies in the field of international development. Specifically, we examine the central research question of what China's impacts, potential and actual, upon development thinking and policies are. The reason why we focus on **potential** impacts as well is that it often takes time for development thinking and policies to change. Hence, we aim to capture initial signs of changes, if any. Such changes may be attributed to either conscious influence by China, or responsive changes by other actors owing to China's behaviours. As China's impact upon development thinking and policies is an unfolding process, our inquiry is preliminary. And our study is empirical in nature, capturing and analysing why and how China's development experiences and practices may deviate from mainstream approaches.

To tackle the above research question, we need an analytical angle that helps explain how China has achieved economic structural transformation. We will also consider what alternative thinking it may bring to the debates on fundamental questions of how best to achieve development, both as a growth phenomenon and a human development phenomenon. As formulated by Professor Justin Yifu Lin, drawing on China's development experiences, New Structural Economics (NSE) provides such a framework for rethinking development policy. Compared with mainstream development thinking, NSE is new in at least two aspects. First, for developing countries to overcome poverty and low- or middle-income traps, it is important to move labour and other productive resources from low-productivity to high-productivity economic activities in line with latent comparative advantage. Second, NSE promotes the market system and private entrepreneurship, but proposes that the government needs to play a facilitating role in mitigating the constraints on the path to economic structural transformation (Lin 2012).

The rest of this article proceeds as follows. Section 2 explores China's impacts in three dimensions: the development thinking that sets policy agendas; the role of the state in economic development; and the strategic use of SEZs to foster economic transformation. Section 3 concludes with key findings.

2 Detecting China's impacts upon development thinking and policy agendas

2.1 Agenda-setting: structural transformation matters

Economic transformation is the key driving force behind sustainable large-scale poverty reduction. China is home to nearly one fifth of the world's population and has lifted 800 million people out of poverty in the past four decades. It achieved the complete eradication of extreme poverty – the first target of the United Nations 2030 Agenda for Sustainable Development – in 2021, ten years ahead of schedule.⁴ China's development experience shows that economic structural transformation was the underlying driving force for large-scale poverty reduction. As China's White Paper on poverty alleviation states, 'As the largest developing country, China has achieved rapid development in step with large-scale poverty alleviation, and economic transformation in step with the elimination of extreme poverty' (SCIO 2021b).

The prevailing Millennium Development Goals (MDGs)-based poverty reduction approach was a reaction to economic structural adjustments in the 1980s where economic reforms were undertaken to the detriment of investment in human capital and the wellbeing of ordinary people. They were thus also an issue of sustainable development. But the pendulum had swung back too far, shying away from the fundamental challenges of improving productivity, diversifying industrial structures, and moving up the global value chain. While economic growth alone did not automatically lead to welfare improvement for all, economic transformation was a necessary, albeit insufficient, condition for large-scale and self-sustaining poverty reduction (Commission on Growth and Development 2008; Stewart, Ranis and Samman 2018).

Given its domestic development experiences and the capabilities thus created, China then aimed to foster economic structural transformation in the Belt and Road Initiative (BRI) countries to ensure that China's rise would not be a threat but rather a window of opportunity for moving up the global value chain together (NDRC, MFA and MOFCOM 2015; SCIO 2021a; Xu and Carey 2015b; Gu and Kitano 2018). The BRI addresses the infrastructure and connectivity shortfalls underlying premature deindustrialisation (Rodrik 2016) or resource curse (van der Ploeg 2011) in developing countries and opens up new perspectives for inclusive growth in developed countries that have joined the initiative.

One salient binding constraint faced by many developing countries is the lack of long-term finance for basic infrastructure associated with risk appetite, and operational modalities adjusted to local systems and delivery schedules (Gil, Stafford and Musonda 2020; OECD and ACET 2020). The assumption that financial markets would be able to channel capital where and

when it was needed with volumes and time frames that would impact on dynamic structural transformation turned out to be a false hope, and this problem has yet to be fully recognised. Aid agencies largely failed to play a role in providing the intellectual and financial capital to support structural transformation, hence the daunting infrastructure gap that severely constrained the potential of developing countries for economic transformation.

China had tackled its domestic infrastructure financing problem via an entrepreneurial development bank. Created in 1994, the China Development Bank (CDB), after initial setbacks, undertook credit reforms to build firewalls against undue political intervention. In response to a policy gap created by a tax reform in 1994 that centralised revenues, and a simultaneous law against borrowing by local governments, the CDB innovated the Wuhu model to fill the financing gap and incubate the market for urban infrastructure financing (Xu 2017). This Wuhu model used local government financing vehicles (LGFVs) to enable local governments to borrow from the CDB, which became a model that it would replicate across China.

The collateral for these loans was land, the value of which would be multiplied by the infrastructure investment enabled by the LGFV, thus establishing a new local government revenue base. In this way, the CDB became indispensable to urban development, and scaled up its balance sheet with assets reaching well over US\$2tn (Sanderson and Forsythe 2013; Xu 2017). Anticipated increasing land values was the basis for much of this lending expansion. China's large-scale urbanisation and its associated job creation, combined with the investments made in secondary and tertiary education, and trade-oriented SEZs, created an economic miracle just as Robert Lucas had predicted (Lucas 1993). In short, the general lesson from this experience is that entrepreneurial development banking combined with entrepreneurial decentralised government with performance accountability is a very powerful vector.

China is inspiring the renaissance of development banking worldwide (Xu, Ren and Wu 2019). A pilot database on development financing institutions (DFIs) estimated that the total assets of over 500 DFIs are as large as US\$18tn and their annual contribution to the financing of global investment was US\$2.2tn in 2019, accounting for about 10 per cent of the world's investment (Xu, Marodon and Ru 2021). On the multilateral front, China has initiated the Asian Infrastructure Investment Bank and New Development Bank that act as public entrepreneurs (Xu and Carey 2015a). National development banking has been rethought and rehabilitated, first at the Addis Ababa Financing for Development Conference in 2015, and then at national level including in some Organisation for Economic Co-operation and Development (OECD) countries. For instance, the UK Treasury has rewritten its Green Book on public investment criteria,

including a special section on transformation (HM Treasury 2020). China's policy banks are being emulated by the US in the form of the new US International Development Finance Corporation and a revived US Ex-Im Bank to compete with China.

Partly due to China's impacts, economic transformation is now taking equal place alongside human development in the field of international development. Indeed, they are seen as interactive parts of a holistic development process. Economic structural transformation is at the heart of the Sustainable Development Goals (SDGs), which succeeded the human development-based MDGs at the United Nations. SDG 8 is to 'promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all' (UN 2015). SDG 9 goes a step further, proposing to 'build resilient infrastructure, promote inclusive and sustainable industrialization and foster innovation' (*ibid.*).

Manifestly, the Chinese experience and the BRI have influenced international thinking (Gu, Corbett and Leach 2019; Carty and Gu 2021). In many OECD countries, including in the UK and the US, infrastructure maintenance and renewal and the challenges of the energy transition are frontline issues, with previously unimagined scaled-up financing. The communiqué of the UK-hosted G7 meeting reflects this influence and ends with mandating a Task Force to produce proposals for a G7 programme to match the BRI (G7 Research Group 2021).

China has proactively shaped policy priority towards structural transformation in international organisations and fora (IDA 2017). In the World Bank Group's International Development Association (IDA), on a proposal from China, it was agreed in 2016, to prioritise jobs and economic transformation in its operations at the eighteenth replenishment of the IDA. Recognition at the World Bank of the importance of economic transformation was largely driven by China's proactive efforts. In the context of the triennial Forum on China–Africa Cooperation (FOCAC), the extensive roadmaps outlined in the action plans are explicitly set in a comprehensive pan-African transformation framework, covering investments in social, production, and infrastructure sectors and linked to China's ongoing transformation (MFA 2018).

In summary, China's development experiences indicate that economic transformation is a key engine for large-scale poverty alleviation in a sustainable manner. Inspired by its own domestic experiences, China has proactively promoted economic transformation in the BRI countries and shaped the development agenda at the World Bank and more widely towards job creation and economic transformation.

2.2 The return of industrial policy

If it is important to achieve structural transformation, then what kind of roles, if any, can governments play in achieving this

objective? During the past four decades, China has successfully lifted itself from low-income country status and is likely to march into high-income country status during its 14th Five-Year Plan (2021–25). Industrial policy has been actively deployed by both local and central Chinese governments to improve productivity and climb up the global value chain. Industrial policies are those policies that help shape the sectoral composition of an economy. Yet not all industrial policies work well in China. Drawing on development experiences and lessons from China, NSE holds that the effective implementation of industrial policy entails the following three essential elements (Lin 2014; Lin and Xu 2018).

First, an effective industrial policy starts with targeting industries with latent comparative advantages. Latent comparative advantage is defined as sectors in which factor costs of production are low by international standards, but where higher transaction costs due to inappropriate soft and hard infrastructure prevent firms from gaining a competitive edge. In learning lessons from past failures, it is important to avoid setting too ambitious a goal of supporting industries that defy the country's latent comparative advantages which are primarily determined by its factor endowments. Otherwise, subsidies and protection may win a competitive edge temporarily but will not be sustainable in the long run, and may even result in entrenched rent-seeking. This new effective policy contrasts with 'old' industrial policies, which failed because they supported industries that defied comparative advantages, so that the high costs of production undermined their competitiveness (Lin and Xu 2019).

Second, an effective industrial policy entails a dynamic analysis of sector-specific binding constraints. Instead of falling into the trap of 'prescription before diagnosis' or 'one-size-fits-all' policy recommendations, NSE emphasises that binding constraints (i.e. those most critical and important constraints) vary on a sectoral basis and change over time. That is why 'horizontal' industry policy (without targeting any specific sector) is not sufficient in releasing the bottlenecks on the path to structural transformation. In short, identifying sector-specific binding constraints in a dynamic way is crucial to the diagnosis of what prevents the country from moving up the value chain, which can lay the foundation for targeted government interventions.

Third, governments need to play a facilitating role in mitigating the binding constraints. Placing emphasis on governmental facilitation is by no means advocating regressing to a command economy. Rather, cautious and well-designed government intervention aims to reduce the transaction costs of sectors with latent comparative advantages by redressing market failures and incubating market institutions. This pragmatic approach can help to go beyond the unproductive confrontation between free market and state intervention and foster synergies between an effective market and a facilitating state.

The success of China's economic miracles with industrial policy stands in sharp contrast to the mainstream development thinking whereby industrial policy has been regarded as an ineffective toolkit. China has proactively used industrial policies and foreign investment to facilitate technology transfer from advanced economies. In fact, history reveals that countries have successfully deployed industrial policy to promote industrial upgrading and structural change both in the past and at present (Amsden 1992; Mazzucato 2014; Wade 1990). Robert Walpole, the *de facto* first British prime minister, is credited to have been the first person to launch a comprehensive infant industry programme in 1721. Walpole strongly influenced Alexander Hamilton, the first US Treasury secretary, who first developed the theory of infant industry protection. Even today, the US government is actively deploying industrial policy to commanding heights in the high-tech industries and fostering innovation (Di Tommaso and Schweitzer 2013). Therefore, when rich industrialised countries advise developing countries to forgo industrial policy, they are kicking away the ladder as they climb up to the top (Chang 2002).

Industrial policy is now back on the agenda of development policymaking. An emerging global consensus is that industrial policy is an important part of the toolkit by which governments can shape the economy for the better. Hence, the key question is not about whether we need industrial policy or not, but rather how to make industrial policy work better (Rodrik 2009). International Monetary Fund (IMF) staff recently published a Working Paper titled *The Return of the Policy that Shall Not Be Named: Principles of Industrial Policy*, which argues that more can be learned from miracles than failures and suggests three key principles behind the success of industrial policy: (1) the support of domestic producers in sophisticated industries, beyond the initial comparative advantage; (2) export orientation; and (3) the pursuit of fierce competition with strict accountability (Cherif and Hasanov 2019).

The Inter-American Development Bank launched an influential report titled *Rethinking Productive Development: Sound Policies and Institutions for Economic Transformation*, which urges that Latin American country governments should not shun active industrial policies even though misguided industrial policy has often done more harm than good in the past (Crespi, Fernández-Arias and Stein 2014). The report argues that 'flatly rejecting all policies that resemble industrial policies because of past failures in the region would amount to throwing the baby out with the bath water' (*ibid.*: 5).

A current criticism is that subsidised Chinese firms with access to cheap finance have created unfair advantages in market shares. This issue is not new to China. The Boeing-Airbus conflict over subsidies has lasted nearly 20 years. In fact, a growing

trend of mutual interdependence between states and firms throughout the world shows that a critical determinant of the success of firms in international markets is that states need to formulate national and sectoral policy to resolve the dilemma inherent in their dealings with foreign firms (Stopforth, Strange and Henley 1991). Yet some subsidies are justified when social returns exceed private returns, a basic rule in economics. Thus, the case for an entrepreneurial 'mission-driven' state is becoming more recognised (Mazzucato 2014). For example, China's support for the photovoltaic solar panel industry has produced a spectacular improvement in efficiency and reduction in price – a huge global return on a Chinese public investment. Similarly, support for Chinese investment in African information technology infrastructure has had an inestimable impact on Africa's economic performance and prospects as well as people's lives (Gagliardone 2019).

In summary, China's economic miracles would not be possible without a facilitating government, though industrial policy sometimes may go awry in practice. This has helped to shift the debate from 'why we need industrial policy' to 'how to make industrial policy work better'. NSE's approach to industrial policy is complementary to the recent discussion on enabling conditions for effective industrial policy (Andreoni and Chang 2019; Chang and Andreoni 2020).

2.3 Special Economic Zones

SEZs became a viable development strategy for China to initiate the reform and opening-up policy in a pragmatic manner in the late 1970s when the overall business environment was poor, market institutions barely existed, and infrastructure deficits were mounting. China introduced SEZs as part of its experimentation towards economic liberalisation. Rather than following the mainstream prescription of improving the 'doing business environment' nationwide, the Chinese government decided to devote its limited resources to improving the soft and hard infrastructure within demarcated areas in order to attract foreign investment to make the export-oriented development strategy feasible (Zeng 2010, 2011).

SEZs are potential instruments for promoting economic structural transformation, and their success requires enabling conditions. Otherwise, despite the best of intentions, SEZs may be ill managed and result in counterproductive consequences. While China's experience cannot be directly replicated elsewhere, it does provide insights into enabling success factors for other developing countries (Lin, Xu and Xia 2020).

First, strong commitment by high-level leadership is the key to unleashing the potential of SEZs. The Shekou Industrial Park and the Shenzhen SEZ would have been non-starters if the high-level leadership had not provided steadfast support for pioneers such

as China Merchants. As every policy initiated in SEZs ran counter to the prevailing policy nationwide, SEZ governance committees needed authority from the highest level to overcome resistance from individual ministries. Otherwise, special policies would not have been fully implemented and SEZs would have lost credibility in the eyes of investors.

Second, it is essential to target the right sectors in line with latent comparative advantages in the given region and adjust the sectoral focus dynamically. Empirical studies show that SEZs can help promote industrial upgrading if the targeted sectors align with the comparative advantages of the local economy (Li and Shen 2015; Chen and Xiong 2015). Yet some local governments blindly set sectoral targets using the industrial structure of well-developed regions as the benchmark. Consequently, those comparative advantage-defying industries have either resulted in overcapacity subsidised by governments (Bao, Tang and Liu 2017) or unsustainable imitation (Deng and Zhao 2018). This suggests that governments need to prioritise sectors with care when designing preferential SEZ policies.

Third, capable and devoted leadership and administration is key to leading investment promotion and building the confidence of potential investors. Developing countries often have limited resources; hence, it is not feasible to improve the soft and hard infrastructure of the whole country within a very short time frame. What is feasible is to enhance the business environment and hard infrastructure within demarcated SEZ areas. A capable and dedicated public administration can help to overcome the first-mover challenge, as foreign investors are often hesitant to enter a zone at the very beginning, even with improved hard infrastructure and business environment.

Crucial to this endeavour is taking an experimentation approach, learning from mistakes, and generating feedback loops. SEZs are by definition an experiment, so trials and errors are inevitable. What matters is that both central government and local governments can effectively build a feedback loop and adjust policies based on successes and failures in practice. The Chinese SEZs may be seen as a way-in-advance application of the Problem-Driven Iterative Adaptation (PDIA) approach now advanced as an optimal strategy for developing state capabilities – an influence, at least, from Chinese experience on development thinking (Andrews, Pritchett and Woolcock 2017).

Inspired by China's economic miracles, the authors find that using SEZs for advancing economic transformation has been increasingly adopted in other developing countries (Lin, Xu and Hager 2018; Knoerich, Mouan and Goodburn 2021). Moreover, the Chinese government has proactively taken efforts to establish overseas SEZs since 2006 to encourage Chinese firms to go global. The Chinese government had no blueprint

for these SEZs and relied on market principles combined with government guidance and incentives to ensure that zones could be sustainable (Brautigam and Xiaoyang 2012).

Although African SEZ performance is often hampered by weak SEZ governance, inefficient bureaucracies, poorly designed legal frameworks (Farole and Moberg 2017), and lack of local autonomy in their own administration (Tang 2019), SEZs have provided a promising new approach to sustainable industrialisation (Brautigam and Xiaoyang 2011). Such an approach stands in sharp contrast to the mainstream approach of applying a uniform benchmark to rank the business environment of all economies worldwide and urging governments to improve the 'doing business' environment against the one-size-fits-all blueprint. Empirical studies have shown that using the World Bank's Doing Business Indicators as proxies for the business environment is problematic (Holden and Pekmezovic 2020).

In summary, inspired by China's example, SEZs are being actively used by developing countries to attract foreign direct investment and foster export-led industrialisation. This approach demands local engagement and vision. The mainstream approach of improving and measuring the 'doing business' environment nationwide failed to capture China's extraordinary success in export-oriented industrialisation. China scored well down the list on the Doing Business Indicators, revealing the limitations of these metrics.

3 Conclusion

From the NSE perspective, China can provide at least three potential lessons for development thinking and policies in the field of international development. First, in terms of agenda-setting (what development is), Chinese policies and experience argue that human development and poverty reduction, which have been an important part of China's own development strategies, are not sufficient alone, and indicate very clearly that economic structural transformation is a prerequisite for sustainable and large-scale poverty reduction and human and social capabilities.

Second, with respect to the role of the state in economic development, Chinese policies and experience show that the market system is essential but needs a facilitating state, with an indispensable role for industrial policy in fostering economic transformation. This does not mean that China's industrial policy is free from flaws. Rather, China's economic miracle with industrial policy helps to shift the debate from 'why we need an industrial policy' to 'how to create synergies between a facilitating government and an effective market to make industrial policy work better' (Ang 2020).

Third, regarding the means of development (how best to achieve development), Chinese policy and experience argues for using

limited state capabilities strategically to improve both hard and soft infrastructure within demarcated SEZs. This will generate export-led industrialisation and facilitate a move up global value chains in the context of a poor business environment and weak institutions nationwide at the early stage of development.

Our analysis above was set in the context of three basic elements of the Chinese scene: massive urbanisation in economic structural transformation; entrepreneurial financing of local government; and the competitive but accountable decentralisation of the economic governance system, producing a Lucas 'economic miracle' (1993) via the high combinatorial value of these three vectors. We note that the Chinese transformation process is now widely acknowledged, though industrial policies are contested internationally even while producing emulation in developed countries. China's development banking system is also producing emulation. Finally, we propose that relevant and adapted elements of the Chinese experience could be powerful vectors in an urbanising African continent of 2.5 billion people by 2050.

Notes

- * This *IDS Bulletin* was produced as part of the UK Anchor Institution for the China International Development Research Network, funded by the Foreign, Commonwealth & Development Office (FCDO). The opinions expressed are those of the authors and do not necessarily reflect the views or policies of IDS or the UK government.
- † We would like to express our gratitude to Professor Justin Yifu Lin and two anonymous peer reviewers for their constructive feedback.
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- 3 The World Bank World Development Indicators.
- 4 Despite the eradication of extreme poverty, the poverty headcount ratio at US\$5.50 a day (2011 PPP) (per cent of population) was still as high as 24 per cent in 2016 according to the World Bank's World Development Indicators. This implies that there is still a long way to go for China to achieve shared prosperity.

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