

The Role of Government in Functional Distribution of Income and Size Distribution of Income¹

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Abstract: Functional distribution of income, also known as distribution of factor income, studies income distribution from the perspective of income source, which is the initial distribution of national income. Size distribution of income, also known as distribution of household income, focuses on the relationship between proportion of population at different strata and proportion of their income, which is regarded as the ultimate distribution of national income. Generally

speaking, the bigger the gap in the functional distribution of income is, the more disparity will be found in the size distribution of income. The third approach to studying national income distribution is to divide end uses, i.e. dividing national output into two end uses including investment and consumption. As the largest economic body in the modern economy, government can affect the functional distribution of income and size distribution of income by adjusting the end use of national output.

Keywords: Functional Distribution of Income, Size Distribution of Income, National Output

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§ I Basic Concepts of Functional Distribution of Income and Size Distribution of Income

1. Difference between functional distribution of income and size distribution of income

Functional distribution of income and size distribution of income are two basic approaches to studying distribution of national income. The former approach, also called distribution of factor income, probes into the relationship between various production factors and income from them, deals with income distribution from the perspective of income source and concerns the share of relative income of capital and labor. While the latter, also known as distribution of personal or household income, discusses total income of different individuals and households and focuses on the share of relative income earned by individuals or families at varied strata. Functional distribution of income mainly concentrates on initial distribution of national income, and size distribution of income takes ultimate distribution of national income into consideration primarily.

Adam Smith, the earliest economist making a study of functional distribution of income in the history, divided income into wage, profit and land rent. In the nature, wage is a sort of labor income, while profit and land rent are classified into capital income. Following Smith, economists such as Ricardo and Marx insisted that income distribution should be studied from the perspective of functional income. Common indicators for measuring functional distribution of income include share of labor income and share of capital income. As lots of composite income could be seen in an economy, for example, income of peasants and petty proprietors in towns, how to break up composite income into labor income and capital income will, to a large extent, affect the calculation of the

said two indicators. In terms of functional distribution of income, the division of income nature involves normative analysis, therefore, modern western economics which lays stress on empirical analysis shifts the focus to size distribution of income from functional distribution.

Pareto was the earliest economist probing into size distribution of income. Under this approach, the source and nature of income will not be distinguished. Taking household (or individual) as analytical unit, households are sorted pursuant to total household income, to analyze the proportion of different households. Such analytical approach could be used to explain the relationship between the proportion of population or household at some strata and the proportion of their income as well as what factors determine the income distribution structure of individuals or households. Common indicators for measuring size distribution of income include 80-20 quantiles, 5 quantiles, Gini Coefficient and Theil Index etc. In the past, Gini Coefficient was often used by economists to measure size distribution of income. Today, Theil Index becomes more and more popular. In the Gini Coefficient approach, the equation of computing Gini Coefficient for discrete data is

$$g = \sum_{i=1}^n \frac{2i-n-1}{n^2} \frac{x_i}{u}$$

and Gini Coefficient could be simply regarded as the weighted sum of relative income $\frac{x_i}{u}$ of all individuals, in which, the weight of

i position is $\frac{2i-n-1}{n^2}$. In contrast, Theil Index approach examines the

deviation of real income distribution from complete equality by calculating the

ratio of income to population. Its equation is $T = \sum_{i=1}^n \frac{y_i}{Y} \log \left(\frac{y_i}{Y/N} \right)$, in which,

y_i indicates the income of i person, Y denotes total income, and N represents total population.

2. Relations between functional distribution of income and size distribution of income

Close relations can be seen between functional distribution of income

and size distribution of income. In general, the bigger the gap in the functional

distribution of income is, the more disparity will be found in the size distribution of income, and vice versa. Any measure that intensifies the gap in the functional distribution of income will affect the pattern of size distribution of income. Functional distribution of income decides size distribution of income¹, deals with income distribution from the perspective of income source and applies analysis based on the principle of economic efficiency. While size distribution of income takes into account of the relationship between size of pollution or household and size of income, the results of which could be used to illustrate the mobility of social classes as well as the formation and trend of income distribution between different social and economic groups. Functional distribution of income decides and affects size distribution of income, because the share of income obtained by the people in an economic group, to a great extent, depends on how many production factors they possess.

Economic system has an effect on the relations between functional distribution of income and size distribution of income. According to the marginal productivity theory of neoclassical economics, functional distribution of income in a perfect competitive market can result in a tendency of equalization of the income of owner of each product factor. But it doesn't tally with reality. For instance, collective bargaining between employer and labor union as well as manipulation of capital, land and product price by monopolist and wealthy landowner for the benefit of personal interests will generate tremendous restrictions on the theory of functional distribution of income.

Both the two distribution approaches lay stress on the causes of income inequality. Two causes could be found in general. One is property income inequality, and the other is wage inequality. The decline of wage will bring about the rise of property income, thus aggravating income inequality. Besides, wage inequality will also give rise to income inequality. In a developing country, income disparity is usually resulted from property income inequality; but in a developed country, wage inequality is the main cause for rise of income inequality. For example, labor income only accounts for about 40% of China's national income, suggesting that income inequality in the country is mainly brought about by the

¹ Chen Zongsheng, *Income Distribution in the Economic Development*, Shanghai: Shanghai Sanlian Bookstore, 1994, p14—16.

inequality in capital income. While in the USA, labor income represents two thirds of its national income, indicating that the contribution of labor income inequality to the country's income inequality is far more than that in China. As commented by Friedman, generally, the widening inequality in labor income which accounts for two thirds of America's national income is the main drive to the rising income inequality in the country¹. And the main cause for widening wage inequality is because of the fast wage growth of workers who have received higher education and mastered advanced technologies. Such points of view, however, neglect the fact that groups with high labor income are also the acquirer of properly income in America. It suggests that labor income inequality and capital income inequality can promote each other. Under the common effect of the two kinds of inequity, America's national income disparity keeps rising.

3. Diagram for the relationship between functional distribution of income, size distribution of income and end use of output

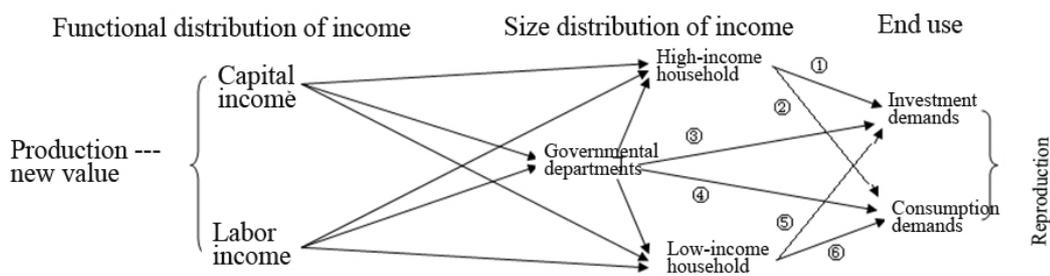


Figure 1 Role of Government in Functional Distribution of Income and Size Distribution of Income

Functional distribution of income and size distribution of income are two basic approaches to the study of national income distribution. In recent years, more and more scholars have realized that, the third perspective should be adopted in the study, that is, end use of national output.

$$\text{End use of national output} = \text{investment demands} + \text{consumption demands} \quad (1)$$

In which, investment demands = government investment + business

¹ Benjamin M. Friedman, Widening Inequality: Implication for Americans' Attitudes and American society, NBER working paper, 2008(3).

$$\text{investment} = \textcircled{1} + \textcircled{3} + \textcircled{5} \quad (2)$$

$$\begin{aligned} \text{Consumption demands} &= \text{government consumption} + \text{household} \\ \text{consumption} &= \textcircled{2} + \textcircled{4} + \textcircled{6} \quad (3) \end{aligned}$$

In the equation (2), business investment is sourced from households. In which, high-income households are considered as the principal of business investment, as companies are often owned by a few high-income households. Nevertheless, investment demands of low-income households are quite limited.

As illustrated in Figure 1, government is excluded from the two distribution approaches. In terms of functional distribution of income, government is the third party irrelevant to labor and capital in the production. This approach only considers the income share of owners of two production factors including labor and capital, and government is excluded because it is not the investor of any production factor. Size distribution of income takes households as analytical units, so a large proportion of government revenues will be transferred to households in the form of transfer income, hence government is also excluded. The advantage of end use approach in the study of national income distribution lies in, that the role of government in the functional distribution of income and size distribution of income can be revealed.

According to Figure 1, three economic bodies are involved in the end use of national output: government, enterprise and household. Fang Fuqian has estimated the proportions of three economic bodies including government, enterprise and household in the end use of national output by means of “basic input and output flows” released in the China Statistic Yearbook¹. In real economy, a continuous spectrum will be formed if sorting household income from highest to lowest. But in Figure 1, households are simply classified into high-income household and low-income household, and high-income household is assumed as the major owner of enterprise. If government is introduced into the functional distribution of income and size distribution of income, the two sorts of distribution will be linked together pushed with the function of government.

¹ Fang Fuqian: *Further Study on Relationship between Government Consumption and Private Consumption*, Economic Perspectives, Issue 12, 2009

§ II Influence of Government on Functional Distribution of Income and Size Distribution of Income

1. Influence of government on functional distribution of income

Based on fundamental theory of Marx, the value of per unit commodity is:

$$z=c+(v+m) \quad (4)$$

In terms of national economy, the sum of commodity values can be expressed as:

$$\sum z_i = \sum c_i = (\sum v_i + \sum m_i) \quad (5)$$

However, strict conditions must be available for the formation of equation (5), that is, all products should be end products, to avoid repetitive calculation of intermediate products.

Two parts can be seen in equation(5), $\sum c_i$ denotes constant capital, i.e. stock; $\sum v_i + \sum m_i$ denotes new value, i.e. flow. Under current national economic statistics, Gross Domestic Product (GDP) is a concept of flow, which only includes the second part in the sum of commodity values, i.e. $\sum v_i + \sum m_i$. Therefore:

$$\text{GDP} = \sum v_i + \sum m_i \quad (6)$$

According to the above equation, GDP is divided into two parts: labor income $\sum v_i$ and capital income $\sum m_i$.

National income distribution in reality is more complicated than that described in the above-mentioned theories. In these distribution approaches, no involvement of government is assumed. However, in modern capitalist countries, revenues disposed by government generally make up 20%-40% of GDP, thus government revenue must be broken down. Government can affect functional distribution of income through two ways. First, government can regulate negotiation force of employer and employee by means of labor legislation, thus affecting the distribution of added value between capital income and labor income. Second, government can regulate capital income and labor income by

imposing different tax rates. For example, corporate income tax can be imposed on capital income, and income tax for wage or salary can be imposed on labor income.

Assuming that all government revenues are from taxes, that is, government has no capital income, the taxes of government can be divided into two types. In terms of objects of taxation, it can be divided into tax on labor income and tax on capital income. In terms of forms of taxation, it can be divided into direct tax and indirect tax. Under different forms of taxation, distribution of national income varies. In real economy, the sources of government taxation mainly include direct tax and indirect tax, but whether it is conducive to capital income or labor income will depend on current situation. In fact, the income of every household belongs to composite income, for it consists of both labor income and capital income. On the whole, high-income households receive capital income primarily, while low-income households usually earn labor income. In case of direct tax, if the threshold for personal income tax and marginal tax rate of progressive income tax are high, high-income households will be adversely impacted, equivalent to levying more taxes on capital income. If the threshold for personal income tax and marginal tax rate of progressive income tax are set at a low level, it will be unfavorable to low-income households, as tax on labor income is raised. In case of indirect tax, it will be hard to analyze whether indirect tax is beneficial to capital income or labor income. For instance, consumption tax on luxury goods will have an adverse effect on high-income households, equivalent to levying taxes on capital income, while distribution of tax burden of value added tax is neutral. Due to little tax distortion effect, value added tax has been a more and more important indirect tax. In case of value added tax, national income is divided into three parts. If disregarding whether government revenues are derived from capital income or labor income, from the perspective of micro-commodity value, equation for calculation of commodity value can be modified as:

$$z=c+(v+m) =c+(v_t+m_t+t) \quad (7)$$

In which, v_t indicates after-tax compensation of employees, m_t denotes after-tax surplus value, and t means government tax revenues.

In national economy, value of all commodities can be expressed as:

$$\sum z_i = \sum c_i + (\sum v_{ii} + \sum m_{ii} + \sum t_i) \quad (8)$$

Gross National Product (GNP) can be calculated as follows:

$$\text{GDP} = \sum v_{ii} + \sum m_{ii} + \sum t_i \quad (9)$$

The three parts in equation (9) are: labor income, capital income and government revenues. In some literatures, labor income is also known as resident income, and capital income is also called corporate income.

2. Influence of government on size distribution of income

Government exerts its influence on final income distribution by regulating expenditure activities. The changes in the size and structure of government expenditures will affect final income distribution.

(1) The influence of government expenditure size on size distribution of income: Changes in the size of government expenditures will, to some extent, exert “crowding-out effect” on expenditures of residents and enterprises. Besides, government’s consumption demands will have similar effect on household consumption, and its investment demands will also inflict “crowding-out effect” on the investment of enterprises. So, is the “crowding-out effect” harmful? The answer is, it depends on the efficiency of government expenditures. In terms of consumer spending, if public goods purchased with government expenditures can make up for the deficiency of resident sector in the supply of public goods, the efficiency of government consumption will be higher than that of household consumption. In terms of investment, if government investment can cover the weakness of private enterprises in the large-scale and long-term investment projects, the efficiency of government investment will be better than that of investment made by enterprises.

It implies that the relationship between government, resident and enterprise must be complementary, not competitive. In case of competitive relationship, the efficiency of government expenditures will be low. In addition, “forced consumption” and “excessive consumption” might be brought about by government expenditures. For example, government may enforce consumption by administrative allocation; and the “three kinds of consumption with public

funds” of governmental departments, i.e. recreational activities, travel and car maintenance, may result in excessive consumption, thus bringing down the efficiency of government expenditures. In the area of investment, government might make investment by restricting private capital, to earn monopoly profit, which will also lower the efficiency of its investment.

(2) The influence of government expenditure structure on size distribution of income: Government expenditures include three types: investment expenditures, consumptive expenditures and social security expenditures. Investment expenditures refer to the investments made by government in infrastructure, regional development, ecological protection and high-tech research and development for the purpose of economic construction; consumptive expenditures mean the expenditures on national defense, public security and public institution management for maintaining normal operation of public administration bodies, which are also called expenditures on public goods and services purchased by government; while the expenditures of government on transfer payment, supporting agriculture, education, medical care and social security in undeveloped areas are classified into social security expenditures. The higher the proportion of social security expenditures in government expenditures is, the more transfer payment will be obtained by low-income population, thus making distribution of social wealth fairer. However, “crowding-out effect” on household consumption (consumption from wage fund) may emerge if consumptive expenditures of government grow too fast.

§ III Contribution of Government to Functional Distribution of Income and Size Distribution of Income in China’s Fiscal Revenues and Expenditures

1. Functional income and size income in China’s national income statistics

China’s national income statistics went through the transformation from MPS system to SNA system. In 1985, the Government introduced MPS system, and in 1993, SNA system was formally put into operation after a period of transition. MPS system focuses on functional distribution of income, which is

calculated as:

$$\text{National income} = (\text{wage} + \text{employee welfare fund}) + (\text{profit} + \text{interest}) + \text{tax} + \text{others} \quad (10)$$

While SNA system concentrates more on end use of national output, which is calculated as:

$$\text{National income} = \text{aggregate consumption} + \text{gross investment} + \text{net exports of goods and services} = (\text{household consumption} + \text{social consumption}) + (\text{fixed asset formation} + \text{increase in inventory}) + (\text{exports of goods and services} - \text{imports of goods and services}) \quad (11)$$

Neither MPS system nor SNA system can directly obtain information about size distribution of income that only involves household without enterprise and government. Size distribution of income assumes that corporate income and government revenues will come down to household income finally, which is generally measured with Gini Coefficient. Next we are going to analyze the status quo of three aspects including functional distribution of income, size distribution of income and end use of national output in China.

(1)Functional distribution of income in China: At present, income approach is adopted in China's national income statistics, that is, added value is broken down into employee compensation, net production tax, depreciation of fixed assets and operating surplus. However, such approach cannot directly reflect the share of labor income and capital income. As considered by Zhou Minghai, Xiao Wen and Yao Xianguo, under such national statistical approach, net production tax is not attributable to labor income or capital income, and the increase of taxes will underestimate the share of labor income. Besides, it will be difficult to break down income of individual laborers in the calculation of our country's labor income. In 2004, all income of individual laborers was regarded as employee compensation in China's statistics. Afterwards, the labor rewards and business profit of sole proprietors are deemed as operating profit¹.

The above-mentioned difficulty in the calculation will affect the absolute

¹ Zhou Minghai, Xiao Wen and Yao Xianguo, *on-balanced Growth of Chinese Economy and Imbalance in National Income Distribution*, China Industrial Economy, Issue 6, 2010.

measurement of labor income share in China, but the effect on relative measurement is not significant. According to the research results of Bai Chongen and Qian Zhenjie, Zhuo Yongliang, Zhou Minghai, Xiao Wen and Yao Xianguo, China's labor income share was in an upward trend in 1978 - 1984; in contrast, its capital income share was falling during this period. In the period from 1984 - 2007, the share of labor income started to descend, while that of capital income began to rise¹.

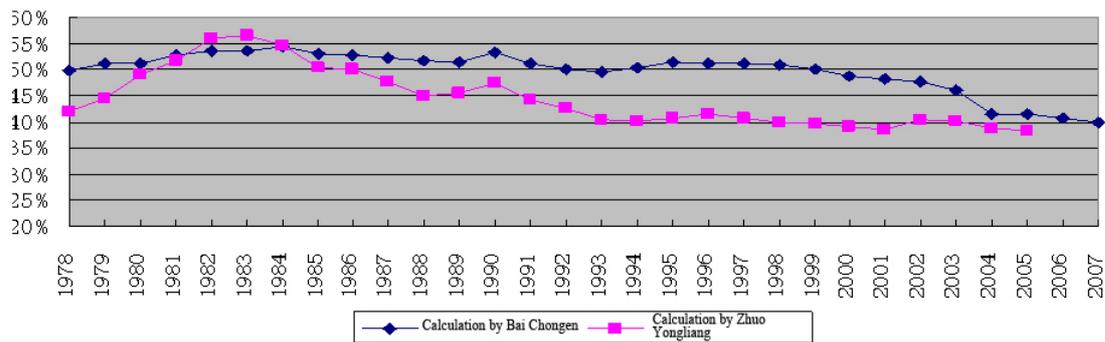


Figure 2 Change of Labor Income Share in China from 1978 to 2007
(Note: in the calculation results of Bai Chongen, data of 2007 was collated by Liu Shejian and others.)

The changes of corporate profit margin can also prove the decline of China's labor income share since 1984. Based on the 1999 - 2007 industrial enterprise statistical database of State Statistics Bureau, Zhang Jie and others built a multivariate regression model. As revealed by sperman related coefficient matrix, an obvious and stable negative correlation can be seen between corporate profit margin and wage per capita, suggesting in China, the higher profit an enterprise earns, the less wage it pays to employees. Moreover, it implies that corporate profit is realized by tying up employees' wage, thus demonstrating the fact of "profit tying up wage" from micro-enterprise level in China².

1 Bai Chongen and Qian Zhenjie: *Factor Distribution of National Income: Story behind Statistics*, Economic Research Journal, Issue 3, 2009; Bai Chongen and Qian Zhenjie: *Who is Tying Up Income of Residents --- Analysis of National Income Distribution Pattern in China*, Social Sciences in China, Issue 5, 2009; Zhuo Yongliang: *Study on Decrease of Labor Income Share and Increase of Capital Income Share*, Social Sciences in Zhejiang, Issue 3, 2007; Zhou Miinghai, Xiao Wen and Yao Xianguo: *Non-balanced Growth of Chinese Economy and Imbalance in National Income Distribution*, China Industrial Economy, Issue 6, 2010.

2 Zhang Jie and Huang Taiyan: *Study on Wage Trends and Decision Mechanism of Chinese Enterprises*, China Industrial Economy, Issue 3, 2010.

(2) Size distribution in China: Wang Zuxiang (2009) made an estimation based on the data on income distribution in the China Statistical Yearbook (1995-2005), and he found that Gini coefficient for Chinese urban and rural areas stayed at a low level, less than 0.34. But since 2003, the aggregate Gini coefficient of China has exceeded 0.44, far more than the warning level 0.4. Wang thought that the urban-rural income gap should be the main cause for increasingly expanding inequality in China. It is true that retarded wage growth of rural migrant workers contributes to the widening income gap between urban and rural areas. The fundamental cause, however, should be the rapid growth of capital income (property income) of urban residents. Since China's reform and opening-up, more and more rural migrant workers have flowed into cities, making the proportion of wage in rural households rising year by year. In 1984—1996, the proportion of wage of rural migrant workers in the net income of rural households increased to 23.59% from 17.17%¹. And in 2008, the proportion climbed up to 37.42%. The highest proportion went to Shanghai, i.e. 70%, compared with 40% above in eastern coastal areas.

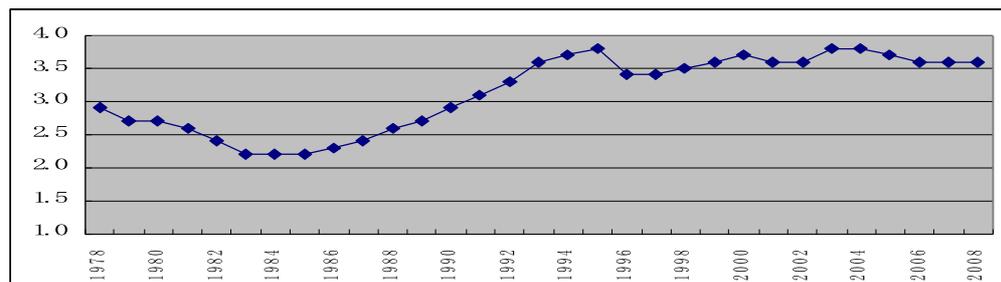


Figure 3 Comparison of Consumption Level in Chinese Urban and Rural Areas from 1978 to 2008

(Source: *China Statistical Yearbook 2009*.)

Figure 3 compares the consumption level of urban and rural residents in China. As shown by the Figure, soaring gap could be seen in terms of consumption level from 1984 to 1995. Since the mid-1990s, the consumption level of urban residents has been more than 3.5 times of that of rural residents. The widening income disparity between urban and rural areas, on one hand, is

¹ Source: Wang Guanghua, *Economic Development and Income Inequality: Mythology and Evidence*, Shanghai: Shanghai Sanlian Bookstore, 2006, p209.

driven by the higher labor income of urban residents relative to rural ones; on the other hand, it is because that the property income of urban residents is higher than that of rural residents too.

(3) End use of national output in China: The existing national income statistics of China, based on total income approach, divides national income into employee compensation, net production tax, depreciation of fixed assets and operating surplus; and gross domestic product (GDP) is divided into final consumption expenditure, gross capital formation and net export of goods and services based on expenditure approach. In this way, a relationship is established between functional distribution of income and end use of output. Such division approach can calculate capital formation rate (investment rate) and final consumption rate; in which, final consumption expenditures can be further broken down into household consumption expenditures (urban and rural areas) and government consumption expenditures. Figure 4 below shows the difference in statistical items of income approach and expenditure approach used in China's national income statistics.

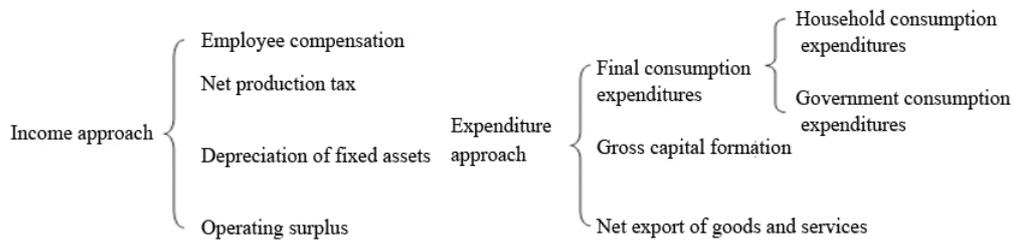


Figure 4 GDP Composition based on Income Approach and Expenditure Approach in the China Statistical Yearbook

Table 1 lists China's GDP composition measured with expenditure approach. The advantage of expenditure approach is that it can conveniently measure final demands. Final consumption, investment and net export constitute three end uses of national income.

Table 1 China's GDP Composition from 1978 to 2008 (based on expenditure approach)

Year	Percentage of final consumption expenditures %	Percentage of gross capital formation %	Percentage of net export of goods and services %	Year	Percentage of final consumption expenditures %	Percentage of gross capital formation %	Percentage of net export of goods and services %
1978	62.1	38.2	-0.3	1994	58.2	40.5	1.3
1979	64.4	36.1	-0.5	1995	58.1	40.3	1.6
1980	65.5	34.8	-0.3	1996	59.2	38.8	2.0
1981	67.1	32.5	0.3	1997	59.0	36.7	4.3
1982	66.5	31.9	1.6	1998	59.6	36.2	4.2
1983	66.4	32.8	0.8	1999	61.1	36.2	2.8
1984	65.8	34.2	0.0	2000	62.3	35.3	2.4
1985	66.0	38.1	-4.0	2001	61.4	36.5	2.1
1986	64.9	37.5	-2.4	2002	59.6	37.9	2.6
1987	63.6	36.3	0.1	2003	56.8	41.0	2.2
1988	63.9	37.0	-1.0	2004	54.3	43.2	2.5
1989	64.5	36.6	-1.1	2005	51.8	42.7	5.4
1990	62.5	34.9	2.6	2006	49.9	42.6	7.5
1991	62.4	34.8	2.7	2007	49.0	42.2	8.9
1992	62.4	36.6	1.0	2008	48.6	43.5	7.9
1993	59.3	42.6	-1.8				

(Source: China Statistical Yearbook 2009.)

In the end use of national income, two items including investment and consumption account for the largest proportion. According to Figure 5, China's investment rate kept rising from 1978 to 2008, while final consumption rate declined continuously.

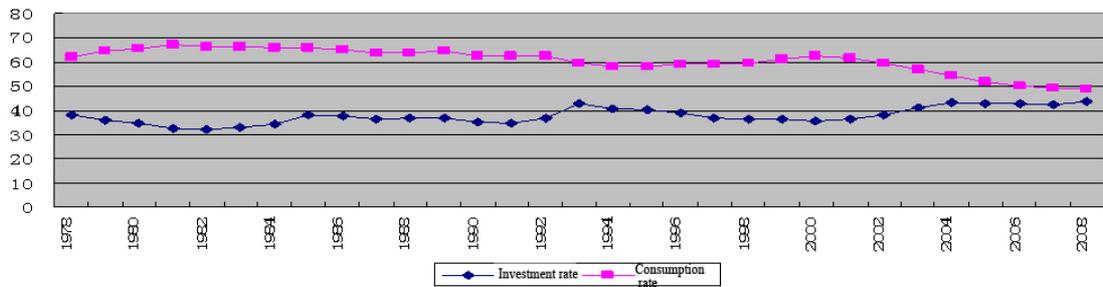


Figure 5 Investment Rate and Consumption Rate in China from 1978 to 2008
(Source: China Statistical Yearbook 2009.)

As indicated by the above analysis, functional distribution of income and size distribution of income are closely pertinent to the end use of national output,

while government receipts and payments act as a significant hub among the three aspects (see Figure 1). Next further analysis will be conducted as for the role of government.

2. Problems with respect to China's financial revenues and expenditures in functional distribution of income, size distribution of income and end use of national output as well as policy recommendations

(1) Problems existing in the functional distribution of income in China and countermeasures: The main problem in the functional distribution of income in China is that the labor income share is too small. Since the 1970s, the proportion of labor income in GDP has maintained at 65% -68% all the time in the USA¹. To ensure sound and stable economic development, Chinese government must improve labor income share in functional distribution of income, which will make an impact on economic growth through the following ways. First, the improvement of labor income share will increase social consumption demands and avoid economic crisis. Second, it will increase the size income of low-income households and narrow the income gap in ultimate distribution, because the major income source of low-income households is labor income. Third, the rise in labor income share will help enhance investment efficiency. According to traditional theories, high-income households constitute the main part of capital investment. However, in modern financial systems, the investment behavior has been socialized and is no longer single capital behavior since developed credit system has facilitated both direct and indirect investments. Labor income will also turn into capital, and low-income households will have capital receipt as well. The improvement of labor income share will transform many wage-earner households to investors, which will be conducive to the formation of middle class in the society.

In China, major measures to improve labor income share, from the perspective of labor legislation, should be rectifying negotiation force of employee and employer; from the perspective of revenue, tax burden on labor income

¹ Hu Jingchun: *Implication of Marx's Theory of Wages to Modern Times*, Economic Study of Shanghai School, Vol. 29, Shanghai: Shanghai University of Finance & Economics Press, 2010.

should be reduced. In another article, Cheng Enfu maintains that employees in China merely get the wage to maintain simple reproduction of labor or even less. Labor force lacks the ability and opportunity to upgrade themselves and improve their qualities, thus they have been caught in the so-called “comparative advantage trap” which implies that low labor value has comparative advantages. It is unsustainable for China to keep the competitiveness of labor-intensive industries by driving down the protection of workers’ rights and interests. Low-end labor-intensive market is the one with nearly pure competition. The economy can be developed sustainably only by improving technical level, grasping core intellectual property rights, building core competitiveness and realizing the upgrade of industrial level. As a socialist country representing the fundamental interests of laboring people, China should, for the benefit of laboring people, initiatively undertake the important task of protecting and improving workers’ rights and interests. By drawing up and effectively implementing the laws and regulations on protection of workers’ rights and interests, relying on positive participation of labor union and workers, together with demanding senior managers in enterprises and relevant business associations, employers’ associations and so on to consciously coordinate with the work, China will be able to effectively protect and improve workers’ rights and interests, establish harmonious socialist labor relations and relationship between employees and employers, as well as lay a solid economic and social foundation for the purpose of building a harmonious socialist society¹

(2) Problems existing in size distribution of income in China and countermeasures: The main problem in the size distribution of income is that the income gap is too wide, which has bearing on the weakening of redistribution function of government. The government plays a very important role in the redistribution of income, so it can exert the function of income redistribution through financial revenues and expenditures.

From the perspective of financial revenues, generally the smaller the proportion of indirect taxes in government revenues is, the greater the proportion of direct taxes will be, and the regulation effect of government on the ultimate distribution of income will be more obvious. Yang Wenfang and Fang Qiyun

¹ Cheng Enfu: *Constructing a State-led Employee Rights and Interests Protection System*, Selected Works of Cheng Enfu, Beijing: China Social Sciences Press, 2010, p723-729.

have carried out a comparative study on the structures of financial revenues and expenditures both in the USA and China. They found that American financial revenues are mainly direct taxes. The proportion of income tax in the US government's financial revenues is always close to 60%, followed by social security tax with the proportion of about 35%. In Chinese financial revenues, the proportion of indirect taxes stands at above 70% all the time. In terms of financial expenditures, US government's financial expenditures mainly include transfer payment and social security expenditures. These two kinds of expenditures have been maintained at about 62% all along. Chinese financial expenditures chiefly contain consumptive expenditures with the proportion always higher than 65%. The next is investment expenditures which stay at 23%-30%. Social security expenditures account for the lowest proportion, lower than 10% all the time.¹ It could be deduced from the above data, American financial expenditures focus on the income distribution function of financial policies, while Chinese financial expenditure structure manifests the macro-control function of financial policies to the economy. In the future, China's financial expenditures should lay particular emphasis on the income redistribution function of financial policies.

In terms of financial expenditures, the direction and structure of financial expenditures will directly influence ultimate income distribution. As manifested by the study of Wang Yiming and others, government administrative expenses significantly expand the income disparity between urban and rural areas in the nation. Nevertheless, regional difference can be found with respect to the impact of expenditures on infrastructure, culture, education, science, sanitation and welfare protection on urban-rural income disparity. In the eastern region, the above expenditures have narrowed income disparity, but in the western region, these expenditures have expanded the income gap. The main causes are: the significant insufficiency of financial input in rural areas and the focus of aforesaid expenditures on cities in western region further enlarged such income disparity². As discussed by Cheng Enfu in another article, the key process to promote consumption is to break the bottlenecks that restrict personal consumption, that

1 Yang Wenfang and Fang Qiyun: *Financial Revenues, Financial Expenditures and Consumption Rate of Residents*, Contemporary Finance & Economics, Issue 2, 2010.

2 Wang Yiming and Cai Xiang: *Empirical Analysis on Financial Expenditure Structure and Urban-Rural Income Gap Based on Data at Provincial Level in Eastern, Central and Western Regions*, Finance & Economics, Issue 8, 2010.

is, improving medical care and social security system for the whole society, raising public investments in basic education, health and hygiene, effectively improving people's consumption expectation, and enhancing consumption propensity¹. According to the above studies, in the future, government expenditures of our country must lay stress on the reduction of government administrative expenses and increase of expenditures on culture, education, science, sanitation and social security in rural areas.

(3) Problems existing in the end use of national output in China and countermeasures: Main problems in the end use of national output include: big investment proportion, small consumption proportion and insufficient aggregate social demands. While insufficient aggregate social demands are resulted by the long-term sluggish household consumption rate which has been an undisputable fact. However, different explanations can be heard for the stagnant household consumption.

The first point of view regards widening income disparity as the cause for sluggish household consumption rate in our country. For example, Yang Wenfang and Fang Qiyun opine that the causes mainly include: first, income disparity has been widened gradually under diversified distribution methods since China's reform and opening-up, resulting in the decline of resident' s consumption propensity; second, the retarded social security system in China increases the uncertainties in revenues and expenditures of residents, bringing about more precautionary savings and decline of social consumption propensity². According to the study of Wu Dong and others, the change of social security expenditures of our country has significantly positive effect on the consumption rate of urban and rural residents³. Social security expenditures have a nature of transfer payment, which can improve income distribution structure and raise social consumption propensity. Similarly, positive effect of expenditures on education and sanitation can also be found on the consumption growth in the society, which is probably

1 Cheng Enfu: *Accelerating the Transformation of Foreign Economic Development Mode Must Realize "Five Controls and Upgrades"*, Selected Works of Cheng Enfu, China Social Sciences Press, 2010, p759-766.

2 Yang Wenfang and Fang Qiyun: *Financial Revenues, Financial Expenditures and Consumption Rate of Residents*, Contemporary Finance & Economics, Issue 2, 2010.

3 Wu Dong and Zhou Peng: *Study on the Effect of Financial Expenditures on Consumption Rate of Residents under Urban-Rural Dualistic Structure*, Contemporary Economic Research, Issue 6, 2010.

due to higher contribution of financial investment in human capital to economic growth relative to the investment in physical capital.

The second point of view considers the crowding-out effect of government consumption on household consumption as the main cause for sluggish household consumption rate in China. For example, Fang Fuqian maintains that income disparity between residents also contributes to the insufficient consumption demands of Chinese residents, but it is not the main course. Since 1996, income distribution in China had been inclined to government, but in 2004, priority started to be given to enterprises. As the “economic cake” is expanding, shares obtained by government and enterprises become bigger and bigger, while the share attributable to residents is shrinking. In the second half of 1997, the short supply turned into insufficient consumption demands from the macro-economic perspective. In developed countries, insufficient demands for investment mainly drive the insufficient aggregate demands; while in China, insufficiency in consumption demands contribute to that in aggregate demands. For example, China's final consumption rate (the proportion of final consumption expenditures in GDP based on expenditure approach) has declined and maintained at a low level since 2000. In 1998 – 2006, its consumption rate was lower than 62% at all time, while the average consumption rate in the world was about 75% in the same period, in which, that of developed countries reached 80%. In the final consumption structure, household consumption and government consumption present a negative correlation. Since 2000, the growth rate of household consumption has been behind that of fixed Assets and GDP in China¹, owing to the rapid economic growth backed by soaring investment in fixed assets.

The above two views seem contradictory, but that's not the truth. The low consumption propensity of residents in China is because of the low proportion of social security expenditures of government, while rapid growth of government consumption results in the falling of household consumption, indicating an unreasonable expenditure structure of Chinese government. If the government can reduce administrative expenses, increase social security expenditures and enhance efficiency of financial expenditures, the problems mentioned above will be tackled.

1 Fang Fuqian: *Study on the Causes for Insufficient Consumption Demands of Chinese Residents – Based on the Data on Urban and Rural Areas at Provincial Level in China*, Social Sciences in China, Issue 2, 2009.

(4) Problems in government expenditures and countermeasures: The size and structure of government expenditures will exert influence on the consumption propensity of urban and rural residents as well as aggregate social demands. Many problems can be discovered in the functional distribution of income, size distribution of income and end use of output, therefore, it is required to control the growth rate and optimize structure of financial expenditures.

First of all, the growth of financial expenditures should be curbed, so as to match economic growth. According to the statistics of World Bank, financial revenues of the countries with per capita GDP of less than USD3000 generally account for 20%-30% of GDP; the ratio for the countries with per capita GDP of USD3000-10000 ranges from 30% to 40%; and that of countries with per capita GDP of above USD20000 stands at 40%-60% in general¹. According to China's per capita GDP, our country's financial revenues should account for 20%-30% of its GDP.

As revealed by the study of Guo Yanqing and others, in 1978 -1992, China's financial revenues represented 30%-50% of GDP, with the average of 37%; in 1993-1999, the proportion dropped to 20%, with the average of 17%. Since 2000, the proportion has been maintained at 20% above, with the average of 23%². It seems that the proportion of Chinese financial revenues in GDP stays in a reasonable range. But some scholars believe, the statistics on Chinese financial revenues have a "leakage", and the actual proportion might be higher. The financial revenues excluded from statistics include: extra-budgetary revenues, revenues not included in the scope of extra-budgetary management, and revenues collected by local governments and undertakings at their own discretion such as various charges, price increase, fund, fund raising and apportioned funds. In view of that, a few economists, based on neo-liberal economic theories, maintain that China should limit its government expenditures.

Neo-liberal economists advocate limiting and reducing the interference of government with market. But it looks like a too idealistic plan. Even in western

1 Chen Xinghong: *Reasonable Adjustment of Proportion of China's Financial Revenues in GDP*, Jiangsu Commercial Forum, Issue 4, 2004.

2 Guo Yanqing and Li Lanying: *Analysis on Current Size of China's Financial Revenues and Optimal Value*, Journal of Central University of Finance and Economics, Issue 12, 2009.

capitalist countries such as USA where the government size is increasingly expanding, the proportion of government expenditures in GDP still stays at a high level at all time. If predicted based on the famous Wagner's Law proposed by Germany economist Wagner in 1882, future government expenditures will keep rising only. According to the Law, positive function relationship exists between functional expansion of a country's government and its national income. With economic development, state's functions will also increase. To ensure the exercise of such functions, the proportion of public expenditures will definitely rise. The Wagner's Law is also known as the "law of increasing public spending" or "law of expanding state activity". Since the human society entered the stage of industrialization and urbanization, the scope of interaction between people has expanded, and public domains for social life have become larger and larger, thus promoting the growth of public expenditures, and also proving the Wagner's Law.

If the Wagner's Law is right, China's financial revenues will keep increasing instead of decreasing in the future. As a result, policy recommendations on reduction of financial expenditures will not match social development in the long run. Nevertheless, in the short term, properly limiting excessive growth of government expenditures will be conducive to the improvement of efficiency of financial expenditures. In recent years, China's revenues have gone up substantially. From 2000 to 2006, the average growth rate of revenues reached 30%, far higher than that of GDP. Currently, the main problems with respect to financial revenues and expenditures that should be tackled by our country include: controlling the growth of financial expenditures at a reasonable rate, making financial expenditures match economic growth, standardizing financial revenues, and reducing extra-budgetary financial revenues.

Second, the structure of financial expenditures should be optimized, and transparency of government expenditures should be strengthened. The main problem in China's financial expenditures is not size, but structure. The structure of our country's government expenditures is unreasonable in many respects. On one hand, non-productive outlays in the financial expenditures grow too fast; on the other hand, transfer payment for public services and social security is gravely insufficient.

According to the research findings of Han Guiying and others, administrative expenses in financial expenditures present an upward trend year by year. In 1998 -2002, such expenses accounted for more than 14% of financial expenditures averagely every year, obviously higher than that of other countries. Han Guying and others opine that rapidly increasing government organs and staff drive the substantial rise of administrative expenses¹. Xu Xiongqi and Zhu Qiubai hold, though the aggregate financial investments ascend in China, the quality declines. Other problems in connection with financial expenditures include: lack of macro-economic control, imbalance of investment structure, lots of repetitive and blind construction projects, payment of salary of government staff and administrative expenses that account for a large proportion in financial revenues. All of these problems bring about reduced efficiency of financial expenditures².

In our country's financial expenditures, expenditures on education, science and technology, culture, sanitation, radio and television, social security, and environmental protection still account for a small proportion, though they have strong social and external effect. The deficiency of these expenditures gives rise to the short supply of public goods and services and severely influences economic and social development in China. A significant challenge faced by Chinese government in the future is, how to transform government functions, enhance government efficiency and turn into a service-oriented government. To realize such transformation, the transparency in government revenues and expenditures must be raised, and social supervision on financial expenditures and revenues must be intensified.

To sum up, government, as an important economic body in national income distribution, acts as a significant guiding role in functional distribution of income and size distribution of income by means of financial revenues and expenditures as well as relevant laws and regulations. As revealed by early research findings of development economics, a government can either significantly facilitate or severely hamper economic development. Neo-liberal economists attempt to exclude the

1 Han Guiying, Mao Yan and Tang Liping: *International Comparison of Financial Expenditure Structure and Revelation for China*, Journal of Southwest University for Nationalities, Issue 10, 2004.

2 Xu Xiongqi and Zhu Qiubai: *Empirical Study on Relationship between Financial Revenues and Financial Expenditures in China*, Journal of Finance and Economics, Issue 3, 2004.

role of government from economy, which simply does not meet the development requirements of market economy. The development of market economy requires to standardize but not to remove the role of government. Whether China's income distribution can be rational and its economy can grow healthily and stably in the future depends critically on whether the function mechanism of government for market economy can be standardized.

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