

# Inclusive Finance, Income Gaps and Common Prosperity

Yin Zhichao<sup>1</sup>, Wen Xiaomei<sup>2</sup>, and Li Chuanzheng<sup>\*3</sup>

<sup>1,3</sup> School of Finance, Capital University of Economics and Business, Beijing, China

<sup>2</sup> China Rongtong Culture and Education Group Co., Ltd.

**Abstract:** According to the Report to the 20<sup>th</sup> CPC National Congress, delivering common prosperity for all the people is an intrinsic requirement of Chinese modernization. Based on China Household Finance Survey (CHFS) data from 2015 to 2019, this study examines the effects of inclusive finance on China's household income disparities and demonstrates how inclusive finance contributes to shared prosperity. Our empirical research reveals that inclusive finance has significantly decreased the income disparities between Chinese households. Inclusive finance has significantly increased the income levels of households below the 40<sup>th</sup> percentile, making it more likely for them to move above the 40<sup>th</sup> percentile of incomes, which is conducive to delivering common prosperity. Our analysis indicates that inclusive finance will reduce income disparities by assisting low-income households in starting a business and by promoting rural household employment. Reflecting its inclusive nature, further investigation reveals that inclusive finance has a greater positive impact on the income level of vulnerable households. Our research offers new evidence for comprehending the role of inclusive finance and a new interpretation of income disparities, with policy implications for accelerating Chinese modernization.

**Keywords:** Inclusive finance, common prosperity, income disparity, entrepreneurship, non-farm employment

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## 1. Introduction

In August 2021, the tenth meeting of the Central Financial and Economic Affairs Commission presided by Xi Jinping discussed solid measures to promote common prosperity. “Common prosperity is an inherent requirement of socialism and a key aspect of Chinese modernization. We must adhere to the people-centered development approach and promote common prosperity through high-quality development,” said Xi Jinping in his speech at the meeting. At the meeting, it was noted that shared prosperity involves a variety of factors, including equitable income distribution, balanced regional development, coordinated industrial development, and equal access to fundamental public services. Among these, income disparities are an important issue that must be addressed at the economic level in order to attain prosperity for all. The Third Plenum of the 19<sup>th</sup> Central Committee of the Communist Party of China has made important arrangements for China's comprehensive development into a strong socialist modern nation and set the strategic objective of achieving common prosperity by the middle of the 21<sup>st</sup> century. According to the Report to the 20<sup>th</sup> National Congress of the CPC, “Chinese

\* CONTACT: Li Chuanzheng, e-mail: 13931239029@163.com.

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modernization is modernization for the common prosperity of all people. Common prosperity is an inherent requirement of Chinese socialism, and achieving it requires a lengthy historical process. As the very purpose of socialist development, we must endeavor to fulfill the aspirations of the people for a better life, make every effort to safeguard and promote social fairness and justice, deliver prosperity to all the people, and resolutely prevent social polarization”.

Currently, China’s principal social contradiction has evolved into one between unbalanced and inadequate development and the people’s ever-growing needs for a better life. The unequal distribution of income is a manifestation of unbalanced and inadequate development, and it hinders the achievement of common prosperity. During the early stages of reform and opening up, China’s Gini coefficient was approximately 0.382 (Adelman and Sunding, 1987). Since then, China’s Gini coefficient has steadily increased, peaked in 2008, and remained around 0.470 in recent years. Increasing income disparities have a negative effect on China’s economic development and social stability (Chao and Shen, 2014), as evidenced by rising housing prices (Xu and Chen, 2016), worsening consumption inequalities (Alesina and Rodrick, 1994), and declining household health levels (Zhou et al., 2014; Deaton, 2003). How to reduce income disparities and improve people’s welfare is a major question for China’s social and economic development.

Academics have always been concerned with income disparities. Existing research has offered explanations for income gaps from both macroscopic and microscopic perspectives, including exports (Zhang, 2015), internet development (Cheng and Zhang, 2019), tax reform (Chen and Li, 2020), government development strategy (Chen and Lin, 2013), urbanization (Lu and Chen, 2004; Zheng and Wu, 2013), trade openness (Guo and Nihe, 2020), industrial transition (Wu et al., 2018), household registration system (Wan and Li, 2013; Wu and Zhang, 2014), education (Yang et al., 2015), labor migration (Yu and Pan, 2019), and pension insurance (Yang and Deng, 2020; Ji et al., 2022).

Released in November 2013, the *Decisions of the CPC Central Committee on Major Issues Regarding the Comprehensive Deepening of Reforms* explicitly called for “developing inclusive finance”, elevating inclusive finance to a national development strategy. The State Council enacted the *Development Plan for Promoting the Development of Inclusive Finance (2016-2020)* by the end of 2015, which defines inclusive finance as the provision of sufficient, effective, and appropriate financial services to people with a demand for such services, regardless of their social status, in accordance with the principles of equal opportunity and business sustainability. In recent years, there has been a strong connection between inclusive finance and key national strategies such as poverty reduction, countryside revitalization, and common prosperity, highlighting the political, economic, and social significance of inclusive finance. Inclusive finance places a stronger focus on equal access to financial services than traditional finance, with the aim of providing economic entities otherwise excluded from the financial system with affordable financial services.

Based on China Household Finance Survey (CHFS) data from 2015 to 2019, this study examines the effects of inclusive finance on China’s household income disparities and the role inclusive finance plays in achieving common prosperity. Our findings indicate that inclusive finance has substantially decreased China’s household income disparities. To address the endogeneity problem that may exist in the model, we perform an endogeneity treatment using a two-way fixed effect model and the instrumental variable method, and the results are robust. Our findings also indicate that inclusive finance has significantly increased the income levels of households with incomes below the 40<sup>th</sup> percentile and households in relative poverty, as well as the likelihood of households moving above the income threshold of the 40<sup>th</sup> percentile, which is conducive to common prosperity. Our research indicates that inclusive finance will make it more likely for low-income households to start a business and encourage non-farm employment among rural households, thereby reducing income disparities. Further analysis finds that inclusive finance has more significantly positive effects on rural and agricultural households with low-social-capital, low-human-capital, low-material-capital, or living below the poverty line. This demonstrates the

accessibility and affordability of inclusive finance.

## 2. Literature Review

This study investigates whether inclusive finance may reduce household income disparities in China and promote common prosperity. Our literature review is conducted from the following perspectives: First, an investigation into research concerning the effects of financial development. Levine (1997), Rajan and Zingales (1998), and Levine et al. (2000) suggested that financial development may stimulate economic growth. As one of the most important variables in economic growth, whether financial development contributes to the reduction of income disparities is a fascinating field of research for economists and policymakers. However, scholars have not yet reached a consensus regarding the effects of financial development on income disparities.

Financial development entails the provision of superior and more convenient services to “regular customers” of financial services, the majority of whom belong to the high-income bracket. This will facilitate the high-income group’s participation in financial markets, encourage the reasonable allocation of their assets, increase their incomes, and thereby exacerbate their income disparity with the low-income population (Greenwood and Jovanovic, 1990). Townsend and Ueda (2006) discovered through a simulation using Thai data from 1976 to 1996, that when the financial system is insufficiently liberal and accessible, only a small number of high-income individuals may benefit from financial development. The income disparity between urban and rural households has widened in China as a result of the country’s financial development (Ye et al., 2011).

Based on its scope, financial development makes financial services accessible to more businesses and individuals, including low-income individuals who would not otherwise have access. Increasing access to financial services will expand low-income individuals’ economic opportunities and further narrow income disparities (Becker and Tomes, 1979; Aghion and Bolton, 1997). According to Galor and Moav (2004), the development of financial markets and intermediaries contributes to the elimination of market imperfections and the alleviation of liquidity constraints for the impoverished, thereby reducing income disparities. Financial services’ anti-poverty effect should be a key factor in the reduction of income disparities. Beck et al. (2007) reveal that financial development may alleviate poverty, whereas poverty reduction may reduce the income disparities between poor and non-poor households.

There is an inverted U-shaped relationship between financial development and income inequality. After reaching a certain level of economic development, income disparities will diminish. However, before this point, financial development will significantly exacerbate income disparities. In the early stages of financial development, only high-income individuals have access to and may profit from premium financial markets. When economic development reaches a higher level, a greater number of individuals will have access to the financial market. Greenwood and Jovanovic (1990) developed the first dynamic equilibrium model for financial development, economic growth, and income distribution to illustrate the U-shaped relationship between financial development and income disparities. In addition, empirical research uncovered a U-shaped impact of financial development on the distribution of income (Qiao and Chen, 2009).

The second part of our literature review focuses on the outcomes of inclusive financial development. Zhang et al. (2019) found that inclusive finance may reduce income disparities and promote inclusive economic growth. Yin et al. (2017) examined the effect of inclusive finance on household income disparities in the Beijing-Tianjin-Hebei region and discovered that inclusive finance served to reduce income disparities. Urban-rural income gaps are an essential manifestation of China’s income gaps, while the development of inclusive finance helps to promote economic growth, reduce financial exclusion in rural areas, and narrow urban-rural income gaps. According to Turégano and García-Herrero (2018), inclusive finance may greatly narrow income disparities and is crucial to income growth

for low-income households and access to credit for small and medium-sized businesses. Becker and Tomes (1979) claimed that inclusive finance would increase economic opportunities for low-income groups, thereby decreasing the inter-generational continuity of relative income. Inclusive finance has the potential to reduce poverty. Focusing on equal access to financial services, inclusive finance permits economic entities excluded from the financial system to access financial services at an affordable price. However, financial development is more concerned with the expansion of financial transactions and the improvement of the financial industry's sophistication. Inclusive finance is measured by whether rural and agricultural households with limited material, human, and social capital or living below the poverty line have access to modern financial services.

The last component of our literature review focuses on common prosperity. Currently, China's principal social contradiction has evolved into one unbalanced and inadequate development and the people's ever-growing needs for a better life. Key to the Chinese people's desires for a better life is the pursuit of common prosperity. Achieving common prosperity is therefore an essential means of resolving China's foremost social contradiction. There is only a small amount of research on common prosperity, the majority of which is qualitative. The nature of common prosperity, according to Liu et al. (2021), is to enable everyone to contribute to and participate in the improvement of living standards at the political, economic, and social levels. Common prosperity implies that everyone should have equal access to basic public services and opportunities for social mobility, without being subject to wealth polarization. According to Li (2021), the concept of common prosperity encompasses four elements: First, the eradication of absolute poverty; second, the delivery of common prosperity to all people; third, a balance of material wealth and cultural prosperity; and fourth, the reduction of income disparities. There are disparities in income between regions, urban and rural areas, and social categories. The creation of fundamental institutional arrangements for primary distribution, redistribution, and tertiary distribution, according to Sun and Cao (2022), is an essential means of promoting common prosperity. At the economic level, income equality is an essential component of common prosperity, so reducing income disparities is conducive to attaining common prosperity. This study investigates the effects of inclusive finance on household income disparities in China and clarifies the role inclusive finance plays in promoting common prosperity.

Compared to previous research, this paper makes three contributions: First, it utilizes nationally representative CHFS data to examine the relationship between inclusive finance and income disparities from a microscopic perspective in order to provide new evidence for understanding the decisive factors of the role of inclusive finance and its determinants. Second, the mechanism in which inclusive finance contributes to the reduction of income disparities is analyzed from the perspectives of entrepreneurship and non-farm employment, thereby revealing the avenues of inclusive finance's effects. Moreover, our findings indicate that inclusive finance has greater positive influence on the income levels of rural and agricultural households with low levels of social, human, material capital or living below the poverty line. Thus, inclusive finance is conducive to social welfare promotion. Thirdly, our analysis of the income-increasing effect of inclusive finance for the low-income group and its contribution to the likelihood of households becoming middle-income and high-income groups demonstrates the positive role inclusive finance plays in promoting common prosperity. Our research indicates that inclusive finance has narrowed the income disparities between Chinese households, thereby contributing to the development of a society that is more inclusive and conducive to common prosperity.

### **3. Data Source and Empirical Model**

#### **3.1 Data Source and Sample Selection**

This paper utilizes data from the CHFS conducted between 2015 and 2019 by the Survey and Research Center for China Household Finance of Southwest University of Finance and Economics. The

CHFS employed a three-stage sampling method proportional to the size of the population. This survey has been conducted every two years since 2011, and five rounds of data collection have been concluded to date. The scope of the CHFS data expanded continuously between 2011 and 2019. The most recent sampling of data comprises 345 counties, districts, and cities from 29 provinces, municipalities, and autonomous regions. In terms of age structure, urban and rural population structure, and gender structure, CHFS data is consistent with data from the National Bureau of Statistics (NBS) and is nationally representative household-level data (Gan et al., 2015). Based on survey data from 2015 to 2019, we have screened samples as follows: Samples of households headed by individuals aged 18 to 75 have been retained; communities with fewer than 10 surveyed households have been excluded. We have winsorized household incomes per capita during the respective sample period by 1% at both ends to eliminate the impact of outliers. We have obtained the non-equilibrium panel data for three phases between 2015 and 2019 with a total of 3,908 community samples.

### 3.2 Creation of the Inclusive Finance Index

The vast majority of the present research literature (Sarma, 2008; Sarma and Pais, 2011) has created a macroeconomic inclusive finance index at the national or provincial level rather than at the community and household levels. Referencing Yin and Zhang (2020), we identify deposits, lending, commercial insurance, credit cards, and digital financial services as the basic services of inclusive finance. The method for selecting indicators is consistent with the *Plan for the Promotion of Inclusive Finance Development (2016-2020)* objectives for inclusive finance development. This paper selects nine indicators of the above five aspects for the construction of an inclusive finance index based on household survey data from China. The constituent indicators of the community-level inclusive finance index are presented in Panel A of Table 1. This paper will also investigate the relationship between inclusive finance and household income disparities. Using the factor analysis method, we construct an inclusive finance index at the

**Table 1: Explanations of the Constituent Indicators of the Inclusive Finance Index**

Panel A: Explanations of the constituent indicators of inclusive finance index at the community level	
Selection of indicators	Definition of indicators
Deposits	Proportion of households with bank deposit accounts in the community
	Current-year balance of deposits per household in the community (10,000 yuan)
Loans	Proportion of households with access to formal bank lending in the community
	Current-year balance of loans per household in the community (10,000 yuan)
Commercial insurance	Proportion of households with commercial insurance in the community
	Average household spending on insurance premiums in the previous year in the community (10,000 yuan)
Credit card	Proportion of households with credit cards in the community
	Credit overdraft amount per household in the community (10,000 yuan)
Digital financial services	Proportion of households that use digital financial services in the community
Panel B: Explanation of the constituent indicators of the inclusive finance index at the household level	
Selection of indicators	Definition of indicator
Deposits	Whether a household has a deposit account
Loans	Whether a household has a loan
Commercial insurance	Whether a household has commercial insurance
Credit card	Whether a household has a credit card
Digital financial services	Whether a household uses digital financial services

Note: We have performed a linear standardization treatment of the inclusive finance index, so that the range of its value is [0, 100]. An increase in the inclusive finance index by one means an increase in the index by 1%.

household level in the same manner as the index for inclusive finance at the community level. Panel B of Table 1 displays the household-level indicators comprising the inclusive finance index.

### 3.3 Definition of Variables and Descriptive Statistics

**Explanatory variable:** The explanatory variable in this paper is inclusive finance. Following the factor analysis approach, this paper creates a community-level inclusive finance index comprising nine indicators, and performs a standardization treatment of the index, so that the range of its value is [0, 100].

**Explained variable:** The explained variable is income disparity, which is measured by Gini coefficient, Theil index, and MLD index. Gini coefficient is a common indicator for measuring income disparity (Li, 1997; Jin et al., 2011). Referencing relevant research (Zhou et al., 2014; Yin et al, 2017; Chen and Li, 2020), this paper calculates Gini coefficient at the community level (village committee or neighborhood committee) to measure the income disparities at various localities. In addition, Theil index and MLD index are employed to measure the income gaps for a robustness test.

**Control variable:** Referencing Yin et al. (2019), this paper controls for the household head characteristic variable and the household characteristic variable. The names and definitions of all control variables are presented in Table 2.

**Table 2: Names and Definitions of Variables**

Type of Variable	Name of variable	Definition
Explained variable	Income gap	Gini coefficient of community income
		Theil index of community income
		Mean logarithmic deviation (MLD) index of community income
Explanatory variable	Inclusive finance	Defined by factor analysis, and factors include deposits, loans, commercial insurance, credit cards, and digital financial services
Instrumental variable	Average value of the county-level inclusive finance index	Mean value of the inclusive finance indices for other communities of the county
Institutional variable	Business start-up	Household engagement in industrial and commercial business operations (Yes=1; No=0)
	Non-farm employment	Household engagement in non-farm employment (Yes=1; No=0)
Control variable	Average age of household head	Average age of household heads in the community
	Average education of household head	Average education of household heads in the community
	Average proportion of unhealthy family members	Average proportion of unhealthy family members in the community
	Average marital status of household head	Proportion of married household heads in the community
	Average size of household	Average size of households in the community
	Average elderly dependency ratio	Average elderly dependency ratio in the community
	Average underage dependency ratio	Average underage dependency ratio in the community
	Average logarithm of household wealth	Logarithm of household per capita wealth in the community
Community housing property ownership ratio	Proportion of households with housing properties in the community	

Table 3 provides the descriptive statistics of relevant variables in this paper. Average Gini coefficient is 0.438, which is above the international alert line of 0.400, and the maximum Gini coefficient is 0.784. According to the UNDP and other international organizations, China's Gini coefficient is relatively high, indicating significant wealth gaps. Based on robustness considerations, this paper employs Theil index and MLD index for the measurement of income disparities at the community level.

**Table 3: Descriptive Statistics**

Type of variable	Name of variable	Observations	Mean	Standard deviation	Min.	Max.
Dependent variable	Gini coefficient	3,908	0.438	0.095	0.155	0.784
	Theil coefficient	3,908	0.365	0.186	0.041	1.552
	MLD index	3,908	0.458	0.219	0.043	1.621
Independent variable	Inclusive finance	3,908	39.312	19.633	0	100
Control variable	Average age of household heads	3,908	53.577	5.288	28.875	66.900
	Average marital status of household heads	3,908	0.878	0.087	0.419	1.000
	Average education of household heads	3,908	8.937	2.385	0.000	18.333
	Average size of households	3,908	3.447	0.800	1.727	7.611
	Average underage dependency ratio	3,908	0.106	0.053	0.000	0.383
	Average elderly dependency ratio	3,908	0.194	0.110	0.000	0.716
	Average proportion of unhealthy family members	3,908	0.168	0.110	0	0.732
	Home ownership ratio in the community	3,908	0.923	0.103	0.091	1.000
	Logarithm of average household wealth	3,908	11.946	1.234	-8.794	16.877

### 3.4 Model Specifications

This paper employs a two-way fixed effect (fixed effects, FE) model for the analysis of the impact of inclusive finance on China's household income disparities with the following model specifications:

$$Inequality_{it} = \beta_0 + \beta_1 \times Financial\_Inclusion_{it} + \beta_2 X_{it} + \mu_i + \lambda_t + \varepsilon_{it} \quad (1)$$

In equation (1),  $i$  denotes community;  $t$  is year.  $Inequality_{it}$  is the MLD index of income, representing income disparities,  $Financial\_Inclusion_{it}$  is the inclusive finance index,  $\beta_1$  is the coefficient under the attention of this paper for the measurement of the income disparity effect of inclusive finance, and  $X_{it}$  is control variable. Considering that the model needs to control for community-level characteristics that do not change with time, we include the fixed effect of community  $\mu_i$ ; considering the time effect, we include the fixed effect of time  $\lambda_t$ ;  $\varepsilon_{it}$  is the stochastic disturbance term.

The fixed effect model may address the impact of unobservable factors that do not change with time on the estimated results. With the change of time, however, unobservable factors may still cause endogeneity in the variable of  $Financial\_Inclusion_{it}$  in the model, thereby triggering a deviation in the estimated results. Hence, we adopt an instrumental variable (Instrumental Variable, IV) to further enhance the reliability of model identification. The instrumental variable will be elaborated in the subsequent sections.

## 4. Empirical Results

### 4.1 Inclusive Finance and Income Disparities

Table 4 presents the estimated results of baseline regression. In the regression, we have controlled for the household head and household characteristic variables while also introducing the fixed effects of community and year. Column (1) is the regression results of Gini coefficient with respect to inclusive finance, and the regression coefficient of inclusive finance is -0.001, which is significant at the 1% confidence level; column (2) is the regression results of Theil index with respect to inclusive finance, and the regression coefficient is -0.001, which is significant at the 1% confidence level; column (3) is the regression results of the MLD index with respect to inclusive finance, and the regression coefficient is -0.002, which is significant at the 1% confidence level. Results in all the three columns of Table 4 suggest that inclusive finance has a significantly negative impact on income disparities. Specifically, an increase in the inclusive finance index by each 10% is associated with a decrease in Gini efficient by 0.01, a decrease in Theil index by 0.01, and a decrease in the MLD index by 0.02, which have great economic significance.

**Table 4: Inclusive Finance and Income Disparities**

Variable	(1)	(2)	(3)
	Gini coefficient	Theil index	MLD index
Inclusive finance	0.001*** (0.000)	-0.001*** (0.000)	-0.002*** (0.001)
Control variable	Yes	Yes	Yes
Fixed effect of year	Yes	Yes	Yes
Sample size	3,908	3,908	3,908
R <sup>2</sup> value	0.104	0.096	0.102

Notes: \*, \*\* and \*\*\* denote significance of the estimated results at the 10%, 5% and 1% confidence levels, and standard errors in parentheses are heteroskedastic-robust standard errors. The same below.

Endogeneity bias may exist in the estimated results of the baseline regression model. Endogeneity bias is primarily caused by such problems as omitted variables and reverse causality. Aside from such factors as household head characteristic variables and household characteristic variables controlled for in this paper, it is likely that other unobservable variables or variables that may not be accurately measured also have an impact on income disparities, such as environmental, regional or cultural factors. On the other hand, financial resources and services are less available in communities with wider income disparities. Therefore, an instrumental variable is introduced in this section to mitigate the problems of omitted variables and reverse causality.

Generally speaking, there is a positive correlation between the level of inclusive finance in other communities of the county and the level of inclusive finance in the county under investigation; however, no direct relationship exists between the level of inclusive finance in other communities of the county and income gap of the county under investigation. Hence, this paper adopts the mean inclusive finance index of other communities in the county as the instrumental variable of the inclusive finance index in the communities under investigation.

Table 5 presents the estimated results of the instrumental variable's regression. Column (1) is the regression results of Gini coefficient with respect to inclusive finance, and the regression coefficient of inclusive finance is -0.002, which is significant at the 1% confidence level; column (2) is the regression results of Theil index with respect to inclusive finance, and the regression coefficient is -0.004, which is significant at the 1% confidence level; column (3) is the regression results of MLD index with respect to inclusive finance, and the regression coefficient of -0.007, which is significant at 1% confidence level. An increase in the inclusive finance index by 10% is associated with a decrease in Gini coefficient by 0.02, a decrease in Theil index by 0.04, and a decrease in MLD index by 0.07, which are of great economic significance.

**Table 5: Regression of the Instrumental Variable**

Variable	(1)	(2)	(3)
	Gini coefficient	Theil index	MLD index
Inclusive finance	-0.002*** (0.001)	-0.004*** (0.002)	-0.007*** (0.002)
Control variable	Yes	Yes	Yes
Fixed effect of year	Yes	Yes	Yes
Sample size	3,840	3,840	3,840
R <sup>2</sup> value	0.114	0.104	0.095



## 4.2 Inclusive Finance and Common Prosperity

Common prosperity is an inherent requirement of socialism and a key aspect of Chinese modernization. The development of inclusive finance will increase the coverage, accessibility and public satisfaction of financial services, thereby mitigating the contradiction between people's growing needs for financial services and unbalanced and inadequate financial development. Specifically, this section will test whether inclusive finance may reduce income disparities and advance common prosperity. Referencing the World Bank's mission "to promote 'shared prosperity' by boosting the incomes of the poorest 40 percent of the population in every country", this section introduces the dummy variable of "household per capita income above the 40th percentile" to investigate whether inclusive finance may increase the probability for households to join the rank of middle- and high-income groups. In addition, the interaction term between the dummy variable "Household per capita income below the 40<sup>th</sup> percentile" and the inclusive finance index is introduced to investigate whether inclusive finance helps low-income households increase their incomes. In order to overcome endogeneity bias, we adopt the mean inclusive finance index of other households in the community as the instrumental variable. Table 6 reports the impact of inclusive finance on the probability for households to join the rank of middle- and high-income groups. Column (1) is the estimated results of the fixed effect model, and the regression coefficient of inclusive finance is 0.002, which is significant at the 1% confidence level; column (2) is the estimated results of the instrumental variable's regression, and the regression coefficient of inclusive finance is 0.003, which is significant at the 1% confidence level. Results indicate that inclusive finance has a significantly positive effect on the probability for households to join the rank of middle- and high-income groups. Judging by the regression results of the instrumental variable, an increase in the inclusive finance index by 10% is associated with an increase in the probability for households to join the rank of middle- and high-income groups by 3.0%.

**Table 6: Contribution of Inclusive Finance to the Probability for Households to Join the Rank of Middle- and High-Income Groups**

Household per capita income above the 40 <sup>th</sup> percentile	(1)	(2)
	FE	FE+IV
Inclusive finance index	0.002 <sup>***</sup> (0.000)	0.003 <sup>***</sup> (0.001)
Control variable	Yes	Yes
Fixed effect of year	Yes	Yes
Sample size	67,907	67,905
R <sup>2</sup> value	0.184	0.184

Table 7 reports the impact of inclusive finance on the household income of low-income groups. Column (1) is the estimated result of the fixed effect model, and the regression coefficient of the interaction term is 0.016, which is significant at the 1% confidence level; column (2) is the estimated result of the instrumental variable, and the regression coefficient of the interaction term is 0.152, which is significant at the 1% confidence level. Results indicate that inclusive finance has a significantly positive impact on low-income households. Judging by the regression results of the fixed effect model, an increase in the inclusive finance index by 1% is associated with a 1.6% increase in the income of households with per capita income below the 40<sup>th</sup> percentile.

**Table 7: Contribution of Inclusive Finance to Income Growth for Low-Income Households**

Logarithm of household per capita income	(1)	(2)
	FE	FE+IV
Inclusive finance index	0.001 (0.001)	-0.037*** (0.007)
Inclusive finance index × Households with per capita income below the 40 <sup>th</sup> percentile	0.016*** (0.002)	0.152*** (0.013)
Control variable	Yes	Yes
Fixed effect of year	Yes	Yes
Sample size	67,907	67,905
R <sup>2</sup> value	0.012	0.046

After the eradication of absolute poverty nationwide, relative poverty has become a focal point of public attention in China. In advancing common prosperity, we should ensure that people in relative poverty will benefit from development and keep pace with social and economic development. Hence, this paper will further discuss the impact of inclusive finance on households in relative poverty. Given that individuals whose incomes are below one third of the average social income are considered as people in relative poverty according to the World Bank, this section introduces the interaction term between the dummy variable of “household per capita income below one third of the average social income” and the inclusive finance index to investigate whether inclusive finance may help households in relative poverty increase their incomes. To overcome the endogeneity bias, we still adopt the mean value of the inclusive finance index for other households in the community as the instrumental variable.

Table 8 reports the impact of inclusive finance on the income of households in relative poverty. Column (1) is the estimated results of the fixed effect model, and the estimated coefficient of the interaction term is 0.018, which is significant at the 1% confidence level; column (2) is the estimated results of the regression of the instrumental variable, and the estimated coefficient of the interaction term is 0.166, which is significant at the 1% confidence level. Results indicate that inclusive finance has a significantly positive effect on the income of households in relative poverty. Judging by the regression results of the fixed-effect model, an increase in the inclusive finance index by one percentage is associated with a 1.8% increase in the income of poor households.

**Table 8: Contribution of Inclusive Finance to the Income of Households in Relative Poverty**

Logarithm of household per capita income	(1)	(2)
	FE	FE+IV
Inclusive finance index	0.001* (0.001)	-0.037*** (0.007)
Inclusive finance index × Households in relative poverty	0.018*** (0.002)	0.166*** (0.014)
Control variable	Yes	Yes
Fixed effect of year	Yes	Yes
Sample size	67,907	67,905
R <sup>2</sup> value	0.009	0.050

## 5. Income Growth Effects of Inclusive Finance

In this section, we will discuss the intrinsic mechanism in which inclusive finance influences household income disparities in China. On one hand, inclusive finance may increase household income by providing households with the financial resources to start a business. Inclusive finance has enabled the development of financial infrastructure to ensure sufficient access to credit for households to start a business and earn more incomes. On the other hand, inclusive finance may also create more jobs that contribute to household income growth. According to a further study by He and Song (2020), inclusive finance is conducive to non-farm employment. Non-farm employment contributes significantly to household income growth, and non-farm employment means the migration of agricultural workforce from less productive agricultural sector to modern sectors that generate higher incomes. In this respect, the income growth effects of inclusive finance are discussed from the two perspectives of entrepreneurship and non-farm employment.

### 5.1 Contribution of Inclusive Finance to Household Entrepreneurship

According to the baseline estimation results of this paper, inclusive finance has significantly narrowed China's household income gaps, and in particular, contributed more significantly to the income growth of low-income people. Further theoretical analysis reveals that credit constraint impedes entrepreneurial activities (Evans and Leighton, 1989), and traditional finance cannot fully support people's entrepreneurial activities; in contrast, inclusive finance is conducive to entrepreneurship by promoting reasonable resource allocation and mitigating financial constraint. For households with low physical and social capital, inclusive finance provides them with much-needed financial resources to start a business and earn more incomes, which is conducive to income equality and inclusive growth (Zhang et al., 2019). That is to say, inclusive finance may inhibit the widening of income gaps by providing households with financial resources to start a business and generate more incomes, and this income growth effect is particularly evident for the low-income group.

Referencing Yin and Guo (2021), Chinese households may be divided into high-income and low-income households by the median per capita income. In this section, we introduce the interaction term between the dummy variable of "Low-income households" and inclusive finance to investigate whether inclusive finance may increase the probability for the low-income households to start a business. In order to overcome the endogeneity error, we adopt the mean value of inclusive finance indices for other households in the community as the instrumental variable.

Table 9 reports the impact of inclusive finance on the entrepreneurship of Chinese households. Column (1) is the estimated results of the fixed-effect model, and the regression coefficient of the interaction term is 0.0003, which is significant at the 10% confidence level; column (2) is the estimated results of the instrumental variable's regression, and the regression coefficient of the interaction term is 0.001, which is significant at the 5% confidence level. Results suggest that compared with high-income households, inclusive finance has made it significantly more likely for low-income households to start a business and earn more incomes (Yin et al., 2019), which is conducive to income equalization (Zhang et al., 2019) and narrowing China's household income gaps.

**Table 9: Effects of Inclusive Finance on Entrepreneurship**

Entrepreneurship	(1)	(2)
	FE	FE+IV
Inclusive finance index	0.001*** (0.000)	0.003*** (0.001)
Inclusive finance × Low-income households	0.0003* (0.0002)	0.001** (0.000)

Entrepreneurship	(1)	(2)
	FE	FE+IV
Low-income households	-0.039*** (0.005)	-0.049*** (0.010)
Control variable	Yes	Yes
Fixed effect of year	Yes	Yes
Sample size	67,907	67,905
R <sup>2</sup> value	0.058	0.055

## 5.2 Inclusive Finance Promotes Non-Farm Employment

Next, the second possible mechanism is tested. Employment is a primary avenue for income growth, and non-farm employment has a more significant income-increasing effect. In this section, we use the non-farm employment of family members as the explained variable and introduce the interaction term between dummy variable of “rural households” and the inclusive finance index to investigate the probability of whether inclusive finance may increase non-farm employment of rural households. To overcome the endogeneity bias, we select the mean value of the inclusive finance indices of other households in the community as the instrumental variable.

Table 10 reports the impact of inclusive finance on the non-farm employment of households. Column (1) is the estimated results of the fixed-effect model, and the regression coefficient of the interaction term is 0.001, which is significant at the 1% confidence level. Column (2) is the estimated results of the instrumental variable regression, and the regression coefficient of the interaction term is 0.005, which is significant at the 1% confidence level. Results indicate that compared with the urban households, inclusive finance has made it significantly more likely for rural households to engage in non-farm employment and thereby increase rural household income. This helps reduce income gaps between rural and urban households.

**Table 10: Effects of Inclusive Finance on Non-Farm Employment**

Non-farm employment	(1)	(2)
	FE	FE+IV
Inclusive finance index	0.001*** (0.000)	0.003*** (0.001)
Inclusive finance × Rural households	0.001*** (0.000)	0.005*** (0.001)
Control variable	Yes	Yes
Fixed effect of year	Yes	Yes
Sample size	67,907	67,905
R <sup>2</sup> value	0.289	0.267

## 6. Further Analysis: Inclusiveness of Inclusive Finance

Inclusive finance is inclusive in that it should provide convenient, safe and reasonable financial services to people from all walks of life, especially those who are economically vulnerable. They include rural households in economically backward regions, households moving to work in cities but still with agricultural household registration (*hukou*), households with low-social-capital, low-human-capital or

low-material-capital, as well as households living below the poverty line. In this section, we test whether inclusive finance benefits all social groups and narrows the income gaps for common prosperity.

### 6.1 Effects of Inclusive Finance on Rural Households

China's policy priority is to eliminate the economic divide between urban and rural areas and promote integrated development. However, academia has not yet reached consensus regarding the effects of inclusive finance on urban and rural income gaps. Some believe that inclusive finance will cause the urban-rural income gap to widen because the financial system functions primarily for the wealthy and rejects the poor. As a result, inclusive finance will exacerbate the poverty of low-income people, rather than narrowing the urban-rural income gap. Others believed inclusive finance would reduce the income disparity between urban and rural areas. This paper divides urban and rural households into two test groups based on their geographical location and focuses on the effects of inclusive finance on rural households.

Table 11 reports the differentiated income effects of inclusive finance under the premise of urban and rural heterogeneity. Column (1) is the regression results of inclusive finance with respect to rural household income, and the regression coefficient is 0.011, which is significant at the 1% confidence level; column (2) is the regression results of inclusive finance with respect to urban household income, and the regression coefficient is 0.005, which is significant at the 1% confidence level. The two columns of results in Table 11 suggest that inclusive finance has a more significantly positive effect on the per capita income of rural households. Specifically, an increase in the inclusive finance index by 1% is associated with an increase in rural household per capita income by 1.1% and urban household per capita income by 0.5%. The above grouped estimated coefficients have passed the coefficient difference test. Compared with urban households, therefore, inclusive finance has more significantly increased rural household incomes. The implication is that inclusive finance is conducive to increasing the incomes of rural households, reducing urban-rural income gaps, and promoting common prosperity by providing access to financial services to rural households otherwise excluded from financial services.

**Table 11: Effects of Inclusive Finance for Rural Households**

Logarithm of per capita household income	(1)	(2)
	Rural	Urban
Inclusive finance index	0.011*** (0.002)	0.005*** (0.001)
Control variable	Yes	Yes
Fixed effect of year	Yes	Yes
Sample size	34,184	68,254
R <sup>2</sup> value	0.025	0.061

### 6.2 Effects of Inclusive Finance for Households with Agricultural *Hukou*

Over the past decade, it has become commonplace for rural residents to migrate and search for work in China's booming cities. Those who have migrated to and settled in cities but still possess agricultural *hukou* are not included into rural households samples. We divide sample households into agricultural and non-agricultural households according to the household registration of household head to investigate whether inclusive finance has helped households with agricultural *hukou* to increase their per capita income. Table 12 presents the estimated results, in which column (1) is the regression results of inclusive finance with respect to household income with agricultural *hukou*, and the estimated coefficient is 0.009, which is significant at the 1% confidence level. Column (2) is the regression results of inclusive finance with respect to the incomes of households with urban *hukou*, and the estimated coefficient is

0.005, which is significant at the 1% confidence level. As the two columns of results in Table 12 suggest, inclusive finance has a more significantly positive effect for the per capita income of households with agricultural *hukou*. Specifically, an increase in the inclusive finance index by 1% is associated with an increase of 0.9% in the per capita income of households with agricultural *hukou* and an increase of 0.5% in the per capita income of households with urban *hukou*. The above grouped estimation coefficients have passed the coefficient difference test. Based on the above analysis, we have found that compared with households with urban *hukou*, inclusive finance has more significantly increased the income of households with agricultural *hukou*. The implication is that inclusive finance has an income-increasing effect for households with agricultural *hukou* and may reduce the income gaps between households with agricultural and urban *hukou*, which is conducive to promoting common prosperity for the whole society.

**Table 12: Effects of Inclusive Finance for Households with Agricultural *hukou***

Logarithm of household per capita income	(1)	(2)
	Agricultural <i>hukou</i>	Urban <i>hukou</i>
Inclusive finance index	0.009*** (0.001)	0.005*** (0.001)
Control variable	Yes	Yes
Fixed effect of year	Yes	Yes
Sample size	56,603	35,051
R <sup>2</sup> value	0.036	0.056

### 6.3 Effects of Inclusive Finance for Households with Low-social-capital

China is a country with highly sophisticated social networks. As an important endowment for households, social network has a major impact on the economic behaviors of households. Yang et al. (2011) found social networks to be conducive to promoting private lending and alleviating household liquidity constraint. Less well-connected households find it hard to alleviate liquidity constraint via private lending, which prevents them from participating in income-generating activities and thereby widens their income gaps with households with strong social networks. Referencing Hu and Zhang (2014), this paper adopts the sum between cash and non-cash incomes and spending of households during festivals, weddings and funerals as the proxy variable for social capital. In this paper, we divided our samples into high-social-capital group and low-social-capital group for a grouped test, focusing on the impact of inclusive finance on households with low-social-capital.

Table 13 reports the estimated results. Column (1) presents the regression results of inclusive finance with respect to the income of low-social-capital households, and the regression coefficient is 0.009, which is significant at the 1% confidence level. Column (2) is the regression results of inclusive finance with respect to the income of high-social-capital households, and the regression coefficient is 0.005, which is significant at the 1% confidence level. The two columns of results in Table 13 suggest that inclusive finance has a more significant positive effect on the per capita income of low-social-capital households. Specifically, an increase in the inclusive finance index by 1% is associated with an increase of 0.9% in the per capita income of low-social-capital households and an increase of 0.5% in the per capita income of high-social-capital households. The above grouped estimated coefficients have passed the coefficient difference test. In a nutshell, we have found that compared with high-social-capital households, inclusive finance has more significantly increased the income of low-social-capital households. This finding suggests that inclusive finance may indeed create a positive effect for the affluence of low-social-capital households, reduce income gaps between low-social-capital and high-social capital households, and promote common prosperity.

**Table 13: Effects of Inclusive Finance for Low-Social-Capital Households**

Logarithm of per capita household income	(1)	(2)
	Low-social-capital	High-social-capital
Inclusive finance index	0.009*** (0.002)	0.005*** (0.001)
Control variable	Yes	Yes
Fixed effect of year	Yes	Yes
Sample size	52,563	49,875
R <sup>2</sup> value	0.036	0.051

#### 6.4 Impact of Inclusive Finance on Households with Low-human-capital

Based on the household-level panel data of China's fixed rural observation points between 2003 and 2010, Cheng et al. (2015) has empirically investigated the relationship between human capital accumulation and farmer households' income growth, and uncovered a significant income growth effect of human capital for farmer households. A key determinant of income growth for farmer households is human capital, which is generally measured by the length of education. Based on the average level of education for the working population, we consider households with an average level of education for working-age population at or below the primary school level as households with insufficient capabilities, which fall into the category of low-human-capital households. Households with an average level of education for working-age population above the primary school level are considered as high-human-capital households for a grouped test, focusing on the impact of inclusive finance on low-human-capital households.

Table 14 presents the estimated results. Column (1) is the regression results of inclusive finance with respect to the income of low-human-capital households, and the regression coefficient is 0.011, which is significant at the 1% confidence level. Column (2) is the regression results of inclusive finance with respect to the income of high-human-capital households, and the regression coefficient is 0.006, which is significant at the 1% confidence level. Results in the two columns of Table 14 suggest that inclusive finance has a more significantly positive effect for the per capita income of low-human-capital households. Specifically, an increase in the inclusive finance index by 1% is associated with an increase in the per capita income of low-human-capital households by 1.1% and an increase in the per capita income of high-human-capital households by 0.6%. The above grouped estimated coefficients have passed the coefficient difference test. Based on the above analysis, we have found that compared with high-human-capital households, inclusive finance has more significantly increased the income of low-human-capital households. The implication is that inclusive finance is conducive to increasing the income level of low-human-capital households, reducing the income gaps between low-human-capital and high-human-capital households, and allowing the people to share in the results of development and achieve common prosperity.

**Table 14: Effects of Inclusive Finance for Low-Human-Capital Households**

Logarithm of per capita household income	(1)	(2)
	Low-human-capital	High-human-capital
Inclusive finance index	0.011*** (0.003)	0.006*** (0.001)
Control variable	Yes	Yes
Fixed effect of year	Yes	Yes
Sample size	30,269	72,169
R <sup>2</sup> value	0.054	0.058

### 6.5 Effects of Inclusive Finance for Low-Material-Capital Households

The low-income group has long been excluded from the formal financial service system and face severe financial exclusion. In this paper, we attempt to discuss whether inclusive finance has helped low-income people to raise their incomes and narrow their income gaps with high-income households. Referencing Zhang et al. (2019), this section divides sample households into high-material-capital and low-material-capital groups according to the median household per capita income. In this section, a grouped regression is performed using the two-way fixed-effect model.

Table 15 reports the estimated results. Column (1) is the regression results of inclusive finance with respect to the income of low-material-capital households, and the regression coefficient is 0.006, which is significant at the 1% confidence level; column (2) is the regression results of inclusive finance with respect to high-material-capital households, and the regression coefficient is 0.003, which is significant at the 1% confidence level. Results in the two columns of Table 15 suggest that inclusive finance has a significantly positive effect on the per capita income of low-material-capital households. Specifically, an increase in the inclusive finance index by 1% is associated with an increase of 0.6% in the per capita income of low-material-capital households and an increase of 0.3% in the per capita income of high-material-capital households. The above grouped estimated coefficients have passed the coefficient difference test. Based on the above analysis, we have found that compared with high-material-capital households, inclusive finance has more significantly increased the income of low-material-capital households. The implication is that inclusive finance is conducive to increasing the income of low-material-capital households, narrowing income gaps between low-material-capital and high-material-capital households, and promoting common prosperity for all the people.

**Table 15: Effects of Inclusive Finance for Low-Material-Capital Households**

Logarithm of per capita household income	(1)	(2)
	Low-material-capital	High-material-capital
Inclusive finance index	0.006*** (0.002)	0.003*** (0.000)
Control variable	Yes	Yes
Fixed effect of year	Yes	Yes
Sample size	51,221	51,217
R <sup>2</sup> value	0.006	0.176

### 6.6 Effects of Inclusive Finance for Households below the Poverty Line

The World Bank has designated a poverty line according to per capita consumption, dividing global populations into poor and non-poor populations. The World Bank has designated the extreme poverty line of 1.9 US dollars based on the purchasing power parity (PPP) of 2011 and the poverty line of 3.1 US dollars based on the median per capita consumption of other developing countries. Considering that the World Bank defines individuals with consumption below 3.1 US dollars as population in relative poverty, we introduce the interaction term between the dummy variable of “household per capita consumption below 3.1 US dollars” and the inclusive finance index to investigate whether inclusive finance is conducive to the income growth of households below the poverty line.

Table 16 reports the income effects of inclusive finance. The estimated coefficient of the interaction term is 0.008, which is significant at the 5% confidence level. Results indicate that inclusive finance is conducive to increasing the income level of households below the poverty line, reducing the income gaps between households below the poverty line and those above it, and thereby promoting common prosperity for all the people.



**Table 16: Effects of Inclusive Finance for Households below the Poverty Line**

Logarithm of household per capita income	Poverty line of 3.1 US dollars
Inclusive finance index	0.006*** (0.001)
Inclusive finance index × below the poverty line	0.008** (0.004)
Below the poverty line	-0.380*** (0.066)
Control variable	Yes
Fixed effect of year	Yes
Sample size	102,438
R <sup>2</sup> value	0.069

## 7. Concluding Remarks and Policy Recommendations

Despite some reductions in recent years, China's income gaps remain significant and unfavorable to the realization of common prosperity. Based on CHFS data of 2015-2019, this paper investigates the effects of inclusive finance on income gaps and common prosperity. To overcome the bias from endogeneity, we employ the panel data fixed-effect model and the instrumental variable (IV) method for estimations, and the results suggest that inclusive finance is conducive to reducing income gaps and promoting common prosperity.

This paper finds that inclusive finance has significantly reduced income gaps for Chinese households. Moreover, inclusive finance has significantly increased the income level of households below the 40<sup>th</sup> percentile and significantly increased their chance to climb above the 40<sup>th</sup> percentile, which is conducive to common prosperity. The mechanism in which inclusive finance affects income gaps is twofold: On one hand, inclusive finance will reduce income gaps by increasing the chance for low-income households to start a business, thereby promoting income equalization and reducing income gaps. On the other hand, inclusive finance will reduce income gaps by increasing the non-farm employment that generates more incomes for agricultural households. Inclusive finance is inclusive in that it creates greater benefits for the countryside, households with agricultural *hukou*, households with low-social-capital, low-human-capital or low-material-capital, and households below the poverty line.

The research results of this paper indicate that inclusive finance is particularly important for narrowing income gaps and realizing common prosperity. Inadequate development of inclusive finance is a key factor behind China's yawning income gaps. Based on the conclusions of this paper, we may arrive at the following policy implications: First, stepping up efforts to develop inclusive finance. The government should increase the level of access to formal financial services for households in the countryside, household with agricultural *hukou*, households with low-human-capital, low-material-capital or low-social-capital, and households below the poverty line. Financial institutions of various types should be guided to improve financial infrastructure, lower the cost of financial services, and reduce financial exclusion to meet the growing demand of households for financial services of various types and promote inclusive finance. These efforts should ensure that the vulnerable group will benefit from access to basic financial services so as to improve their living conditions and promote common prosperity. Second, inclusive financial services should be extended to support entrepreneurship and improve the business climate. Proactive efforts should be made to promote "mass entrepreneurship and mass innovation" and foster a better business environment for entrepreneurship. Households with low-human-capital, low-social-capital or low-material-capital, as well as other vulnerable groups should

be provided with more complete financial services. The government should encourage entrepreneurial activities and provide targeted financial services, leveraging financial resources to address hardships and pain points for business owners. Vulnerable groups should be helped to earn more incomes by starting a business, so as to reduce income gaps and allow all the people to benefit from the country's modernization. Third, improving the policy system for inclusive finance and promoting non-farm employment. The government should utilize inclusive financial resources to improve the skills of rural residents and provide them with more non-farm job opportunities. For rural residents employed in the non-farm sector, banks should develop specific inclusive finance products such as insurance. Inclusive finance should be utilized to support the orderly migration of rural workforce, and provide a better policy environment to rural households employed in the non-farm sector to increase the incomes of low-income people and promote the positive employment effects of inclusive finance. ■

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