5 Chinese Industrialisation:

Path Dependence and the Transition to a New Model

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Introduction

China's economic structure can be characterised as both over-industrialised and under-urbanised relative to its level of income per head. Further, for such a large economy, it is highly export oriented. The design of any new growth model will need to respect these major structural legacies. The 'over-industrialised' assessment reflects a high proportion of secondary activity in gross value added relative to its peers; and the under-urbanised assessment reflects the fact that the policy framework has prevented internal rural–urban migration from progressing at the rate at which push and pull motivations alone would have predicted. Furthermore, the absorptive capabilities of the urban population are diminished by the underprivileged position of the migrant worker cohort. China thus has both a considerable overhang of industrial capacity and considerable latent demand for further urbanisation, alongside huge potential for generating greater benefits from the degree of urbanisation already achieved.

The fundamental inheritance of the current leadership is certainly mixed. Some aspects of this inheritance are an impediment to sustaining growth in aggregate living standards in an environmentally conscious way, while simultaneously promoting equality of income and opportunity. Others are advantageous for the pursuit of these basic national goals. Transitioning the economy in a direction that reduces 'over-industrialisation', optimises urbanisation and increases domestic absorption at the expense of foreign sales will emphasise the positive aspects of the inheritance and de-emphasise the negative. We argue that the overall policy response to these major questions—both the threats and opportunities—can be inherently complementary. Furthermore, we argue that the policy decisions and guidelines issued over the last year or so indicate that the administration understands the need for a new model and has a good idea of what should be done to achieve it. Yet the leadership is not over-confident. Indeed, the State Council memorandum on income distribution reform, which cuts across all relevant aspects of macroeconomic decision-making, released on 5 February 2013, stated that 'deepening the income distribution reform

is a systematic project that is arduous and complicated and concerns the reallocation of various interests. There is no way to accomplish it overnight' (Quoted in Xinhua News 2013a).

The first section of this chapter presents evidence that supports our characterisation of China's current and historical economic structure as both over-industrialised and under-urbanised relative to its level of income per head. This discussion sketches China's path to the present and its structural starting point as it attempts to transition towards a new model. The second section outlines desirable changes in policy structure to accommodate a new model, alongside a discussion of initiatives that have already been put in place to that end by the administration. Following this section we indulge in a political economic aside: noting that the many facets of path dependence present a material *prima facie* political-economic constraint on the Chinese leadership's absolute freedom of choice and action. Even so, we conclude, optimistically, that these constraints should not be considered an insurmountable hurdle. Given the ultimate complementarity of the superordinate goals of China's next transition—reducing 'over-industrialisation' and optimising urbanisation—there is very good reason for the leadership to embark upon the process of deepening reforms with a high degree of resolve.

China's Historical Industrialisation Path in Comparative Perspective

In 1995 China achieved the US\$2,000 per capita level for purchasing power parity GDP. In 2011 it reached the US\$8,000 per capita threshold, quadrupling the size of its economy per head in just 16 years.¹ Leaving aside for a moment the speed at which this increase in living standards has been achieved, which was indeed remarkable, the attainment of a four-fold increase in living standards from a base of \$2,000 per head is a notable feat for any late-industrialising economy in the post-Second World War period, and rarer than one might expect. Some of the notable nations in the Asian region that do not yet meet this criterion (although they may do so in the foreseeable future), despite some periods of impressive economic growth, are Indonesia, India, the Philippines and Vietnam. Given the relative exclusivity of the 'club' to which China earned

1 All information on post-Second World War GDP and GDP per capita levels reported in this chapter are based on the Conference Board's Total Economy Database™ as issued in January 2012, which is available from <http://www.conference-board.org/data/economydatabase/> Data for before 1950 and the world economy as a whole comes from Maddison, Angus, 2009, *Historical Statistics of the World Economy: 1–2006AD*, March update, available from <http://www.ggdc.net/maddison/> All underlying data are 1990 Geary Khamis dollars.

membership in 2011, it provides a neat guide for a comparative analysis of industrialisation and development patterns around the Asian region and around the world. Accordingly, we have selected a sample of economies that share this distinction with China to conduct a peer review of the broadest contours of its development drive.

Before we enter into that discussion, let us turn for a moment to the relative speed at which China executed a quadrupling of living standards. Consider Figure 5.1. The columns represent the number of years each economy took to achieve the feat. The line represents the compound annual growth rate during the relevant period. China is the latest country in the sample to reach the baseline income level, and it achieved the fastest growth rate; and, accordingly, required the least amount of time to increase living standards four fold. Japan comes next, followed by the group of four precocious late industrialisers now known as the ‘Newly Industrialised Economies’, with Thailand and Malaysia also featuring. Two economies from outside the East Asian region—one from the Old World (Turkey) and one from the New (Mexico)—bookend an estimate of the experience of the world economy in total, before the figure moves into the first and second generation of European industrialisers and their colonial offshoots.

Figure 5.1 Quadrupling living standards from a base of \$2,000 PPP GDP per capita

Source: See footnote 1.

Table 5.1 indicates the year in which the countries in Figure 5.1 first reached the baseline level of \$2,000 GDP per capita, going back to the Netherlands in 1827. It also shows when the quadrupling of living standards was completed.

Table 5.1 Quadrupling living standards from a base of \$2,000 PPP GDP per capita

Modern country	Year achieved \$2,000 GDP per head	Year achieved \$8,000 GDP per head	Number of years to quadruple GDP per head	Compound annual growth rate in period
Netherlands	1827	1960	133	1.0
United Kingdom	1839	1957	118	1.2
Australia	1848	1955	107	1.3
United States	1860	1941	81	1.7
France	1869	1962	93	1.5
Germany	1874	1962	88	1.6
Mexico	1950	2008	58	2.4
Hong Kong	1950	1977	27	5.3
Singapore	1950	1979	29	4.9
Japan	1951	1968	17	8.5
Turkey	1955	2007	52	2.7
Taiwan	1965	1985	20	7.2
South Korea	1969	1989	20	7.2
Malaysia	1969	2002	33	4.3
Thailand	1976	2005	29	4.9
China	1995	2011	16	9.1
<i>memo item</i>				
World	1950	2004	54	2.6

Source: See footnote 1.

The first generation of industrialisers took well over a century to quadruple GDP, expanding at a compound rate around one to $1\frac{1}{4}$ per cent per annum, while the second generation (here represented by France, Germany and the United States) achieved growth rates around $1\frac{1}{2}$ to $1\frac{3}{4}$ per cent per annum; this enabled them to complete the task in an average of 87 years.

The availability of national accounts data grew significantly after the Second World War. So too did modern economic growth, underpinned by the dissemination of the industrialisation meme.² Five of the 16 economies listed in Table 5.1 were on the \$2,000 GDP per head ‘starter’s blocks’ in the early 1950s: Japan, Turkey, Mexico and the entrepot-city states of Singapore and Hong Kong. The world economy as a whole was also in that category. Maddison estimates that global GDP per capita had reached \$2,113 in 1950.

2 Bénétrix et al. (2012: 6–7) make a practical observation on the availability of historical time series of industrial output. They argue that the availability of data is itself an indicator of industrialisation, as a poor country without an industrial sector of note would not go to the trouble of computing such statistics. That is certainly a ‘reasonable surmise’, as they put it.

Moving forward to the 1960s, Taiwan (1965) and then South Korea and Malaysia (1969) reached the jumping off point, just as Japan was completing its drive to \$8,000 (1968). Thailand reached the jumping off point in 1976. This group (excluding the special cases of Hong Kong and Singapore) of successful post-Second World War industrialisers are the peer group we have selected for China. As Japan was the first nation among the group to quadruple per capita income, it serves as the anchor for the comparative analysis. Thus in Figures 5.2a and 5.2b, Japan is set at 100 for every indicator, and the other countries are reported as a percentage of the Japanese level. For example, when Japanese GDP per head was at \$2,000 in 1951, its urban population share was 53 per cent. When China's GDP per head was at \$2,000 in 1995, its urban population share was 31 per cent. China's urban share is accordingly represented as 58 per cent of the Japanese level in Figure 5.2a.

In addition to the two major areas of interest to this chapter—industrial production as a share of total output and the urban population as a share of the total—we have selected proxies of human capital (average years of schooling for adults) and infrastructure (rail network length scaled by land area), in addition to life expectancy and the investment share of GDP. Export orientation is also considered, but relative scale factors make it difficult to represent in the same graphical framework as the variables considered above. As a consequence trade orientation is illustrated separately in Figure 5.3.

The most striking finding from Figure 5.2a is China's very high industrial production and investment shares at the starting point of the analysis. Its investment share far exceeded all other economies in the sample and its industrial production share likewise. High industrial production and investment shares are closely associated with China's high energy and resource as well as emissions intensities. It was close to its peers in terms of schooling and life expectancy, but it was weak in terms of infrastructure, and well behind its north Asian neighbours in terms of urbanisation. China's export orientation was much higher than that of Japan, Mexico or Turkey at the \$2,000 per head level, somewhat higher than that of South Korea, similar to Thailand, but much lower than Malaysia.

Figure 5.2a Selected characteristics of successful future industrialisers at the \$2,000 PPP GDP per capita level

All measures reported as a percentage of the Japanese level

Figure 5.2b Selected characteristics of successful future industrialisers at the \$8,000 PPP GDP per capita level

All measures reported as a percentage of the Japanese level

Notes to Figures:

'Schooling' refers to average years of schooling per adult.

Source: United Nations Development Program, available at <http://hdrstats.undp.org/en/indicators/103006.html>

'TVA share' and 'GCF share' refers to the percentage of GDP accounted for by industrial production and gross investment respectively.

Source: World Bank Databank, available at <http://databank.worldbank.org/data/views/variableselection/selectvariables.aspx?source=world-development-indicators>

'Life expectancy' is at birth.

Source: *ibid.*

'Infrastructure' is open rail network length scaled by 2010 land area. Land area comes from the CIA World Factbook, available at <https://www.cia.gov/library/publications/the-world-factbook/index.html>. Rail network length is from Mitchell (1982, 1975, 1993), Union of International Railways (1991, 2000), the CEIC database and the CIA World Factbook, with interpolations by the authors.

'Urban share' is the percentage of the population classed as urban by the United Nations in their 2011 revision.

Source: <http://esa.un.org/unup/>

Figure 5.3 Export orientation at \$2,000 and \$8,000 PPP GDP per capita

Note: Exports of goods and services as a share of GDP.

Source: World Bank Databank, available at <http://databank.worldbank.org/data/views/variableselection/selectvariables.aspx?source=world-development-indicators>

Moving forward to the \$8,000 per head snapshot, and the initial impression is that there is a much greater degree of similarity between the economies in the sample at this stage of development than at the jumping off point. The main exception is in infrastructure, where Japan remained far ahead of the rest of the group. As for China itself, its raw relative rankings on most indicators remained similar to those seen at the \$2,000 per head level, but it looked less extreme in terms of investment share and industrial production as a share of total output, and the degree to which it was lagging in terms of urbanisation declined. The decline in its lead was a result of rising shares in the other countries, while China maintained a high level. The improvement in China's relative standing in terms of urbanisation was a function of rapid increases in China and less rapid gains elsewhere. As for export orientation, China retained substantially greater exposure to foreign demand than the larger economies in the sample (noting that Mexico's participation in the North American Free Trade Agreement (NAFTA) saw it narrow the gap to a degree); South Korea caught China up; while the two Association of Southeast Asian Nations (ASEAN) economies moved far ahead.

This investigation clearly shows that the characterisation of China's economy as simultaneously over-industrialised, under-urbanised and more export oriented than is usual for large economies—all relative to development level—is valid today, just as it was in the 1990s. That is, despite rapid urbanisation in China during the last two decades and despite rapid increases in the industrial production and investment shares of output, and export orientation of sales, in other successful industrialisers in the post-Second World War period. As of 2011, at a GDP per capita level of around \$8,000, China is less atypical than it was in 1995 as a \$2,000 per head economy, but it retains a highly distinctive structure.

Policy Parameters of the Current and Historical Systems

The previous section offered a simple description of the changes in the Chinese economy between the GDP per capita levels of \$2,000 and \$8,000 within a comparative setting. This section established the 'what': the outcomes generated by the historical models of development adopted by successive eras of Chinese policymakers up to the recently installed fifth generation of leadership. We must now consider the 'how' and the 'why': the historical policy framework itself and the outcomes it attempted to facilitate.

To stylise heavily, China's over-industrialised present state is a result of a complex array of price and incentive distortions that have worked to prioritise industrial development, both heavy and light, both domestically consumed and export oriented, over other potential uses of resources. These distortions

pervade both the real and financial spheres of the economy and create an unbalanced underlying structure. Key factor input costs—labour, land, energy and capital, plus the pricing of external diseconomies—have historically been suppressed (Huang and Tao 2010), which raises the return on investment, encourages capital accumulation over consumption and boosts international competitiveness. The result is an unusually high share of industrial value added in total output; an unusually high share of capital formation in total expenditure; unusually high gross savings across the three key institutional sectors (Ma and Wang 2007); and, unusually high export orientation for a large economy.

China's under-urbanised present state is the direct result of an overall policy framework that has prevented internal rural–urban migration from progressing at the rate at which push and pull motivations alone would have predicted (Song and Sheng 2005). The discrimination still exists as practised against migrant workers under the *hukou* system (Watson 2009, Song, et al. 2010), uncertainty over land tenure, and a range of socio-economic factors, such as a social security system that is inaccessible to migrant workers, serve as effective barriers to unfettered rural to urban migration and systematic participation in off-farm work (Démurger 2012). Even so, the stock of migrant workers is large, numbering 253 million people in 2011 according to Andrew Watson (2012: Table 12.1: 282), although the precise number remains contested. Migrant workers and their families are not yet full participants in the lifestyle enjoyed by non-migrant urban residents. The policy objective of optimising urbanisation is at its core a desire to converge the living standards of this large but underprivileged group with those of the rest of urban society, which are hardly standing still.

In the introduction to the previous volume in this series (McKay and Song 2012: 2) we wrote the following:

the pursuit of 'balanced' economic growth is best thought of as a broad policy objective that aims to limit risks to growth and to mitigate the negative impact on welfare. It should therefore not be expressed as a particular target, such as a reduction in the current account surplus or a rise in the labour share of income. The role of policy should be to design and implement a framework that reduces distortions, encourages and rewards innovation, equalises access to education, employment, a social safety net and capital for investment, while minimising rent-seeking opportunities. The desire to achieve such an environment will create demand for institutional reforms that can facilitate these processes of structural change in the least disruptive fashion.' The proposals we advance below are put forward in that spirit.

The recent remarks of the new premier, Li Keqiang, reported by official news agency Xinhua (2013b) are clearly in sympathy with this construct. Speaking at a macroeconomic seminar on 12 April 2013, which brought together policymakers, scholars and industry representatives, Li stressed that the deepening of reform was vital to the sustainability of growth and that any counter cyclical efforts would be considered in the context of their longer term structural implications and their impact on the reform path. The exact reporting was as follows:

'While effectively coping with short-term problems and maintaining reasonable growth, more efforts should be made to improve the quality and benefits of development, with a focus on promoting economic restructuring and upgrading, expanding employment and increasing people's incomes', he said.

He said the impetus for sustained development lies in deepening reform, *urging targeted policies to cure not only 'symptoms' but deeply-rooted problems* in the Chinese economy.

'If interim measures have to be carried out, they should not set up barriers for promoting market-oriented reform and development in the future', he said. (Italics by the authors)

To take those principles and make them more practically actionable, a little taxonomy is desirable. Measures and recommendations can be usefully divided into those that a) directly tackle specific distortions that create rents and skew resource allocation (for instance energy pricing), b) those associated with addressing asymmetric opportunities that lead to and inflame imbalances (for instance the pension system), and c) those that seek to minimise macroeconomic risks, or enhance macroeconomic benefits, in a more general way (for instance financial system reform).

Huang and Tao (2010) put forward the proposition that China's unbalanced economic structure (and the consequent rapid widening of the current account surplus in the 2000s) can be ascribed to what they term 'asymmetric market liberalisation'. They argue that while the goods market is predominately liberalised in China, factor market liberalisation has lagged behind. They produce estimates of producer subsidy equivalents emanating from a range of factor market distortions at an annual frequency between 2000 and 2009. A summary of their results is reported in Table 5.2. This is a good place to move from the general to the specific.

The estimates of Huang and Tao show that material distortions exist in the 'markets' for labour, land, capital, energy and the environment. Each of these distortions serves to lower input costs to business, allowing the estimation of an (admittedly crude) 'producer subsidy equivalent' in each area. These advantages

lead to greater international competitiveness and profitability in many sectors. These excess profits come at the expense of the providers of the good or service whose output price is suppressed, in essence an inter-sectoral transfer. It is principally migrant workers who are disadvantaged by suppressed labour costs; it is the indigenous private sectors who are disadvantaged by barring them from access to finance from the formal banking sector; it is upstream energy suppliers who are disadvantaged by suppressed costs to final users; it is the community of domestic savers who are disadvantaged by the suppressed cost of capital and financial repression more generally; it is the Chinese and global commons, today and into the future, that suffer from the lack of effective pricing of negative externalities such as the environmental degradation; and, it is foreign competitors of Chinese firms who are disadvantaged by the competitive edge bestowed by a suppressed cost base in China. Further, intra-sectoral distortions, such as preferential treatment for state-run or certain foreign invested firms, also serve to skew economic structures, as not all Chinese businesses are equal in terms of their access to cheap factors (especially land and capital), and barriers to entry in many key sectors create further rents for powerful incumbents.

Table 5.2 Producer subsidy equivalents of factor market distortions in China, 2000–2009 (% of GDP)

	Land	Labour	Capital	Energy	Environ	Total
2000	0.5	0.1	4.1	0.0	3.8	8.5
2005	1.3	2.4	3.0	1.7	3.0	11.4
2007	1.2	3.2	3.6	1.6	2.4	12.0
2009	0.9	2.7	3.5	0.7	1.8	9.6

Source: Huang and Tao (2010: Table 5.1).

Approaching the most transparent distortions first, a move towards market-based energy pricing for end users of electricity and petroleum products should be an immediate priority. Moving towards a system that prices negative externalities, thus endogenising a portion of the cost of environmental degradation into the bottom line of business, is a further obvious area for reform. Huang and Tao argue that the combined ‘prize’ of reform in these areas—the reversal of 2009 levels of producer subsidy equivalents—is around 2.5 per cent of GDP annually. There have already been a number of announcements in both areas, and China is by no means new to the taxing of pollutants (OECD 2013: 136), implying both awareness of the problems and a willingness to act on behalf of policymakers. Experimental programs that would price emissions have been initiated in selected administrative regions, while energy efficiency targets have been enshrined in the five-year planning process (OECD 2013: Box 2.1: 125), both nationally and at the large-firm and industry

level. Vehicle emission standards are monitored and enormous investments in renewable energy have been undertaken (Australian Government Department of Climate Change and Energy Efficiency, 2013).

In late March of 2013, some key announcements on energy pricing were made (Taplin and Yao 2013). The liberalisation of coal pricing arrangements inside China, and the administrative willingness to pass on changes in the market prices of energy inputs to end users more frequently and more completely than is currently the case, is an important step towards the use of price signals to guide more efficient energy use. Developments across these areas will help to address the ‘over-industrialised’ aspect of China’s present economic structure, but there is a great deal still to do. Even so, the taxation share of Chinese retail diesel and gasoline prices is low by international standards (OECD 2013: Figure 2.9.: 131) and household and industrial electricity costs are also low (ibid.: 133).

Addressing the distortions associated with capital—where the direct ‘prize’ is close to 3½ per cent of GDP annually and the total prize in terms of macroeconomic stability is arguably considerably larger in the long run—requires a broader approach. Indeed, when Li urged ‘*targeted policies to cure not only “symptoms” but deeply-rooted problems*’, it is an acknowledgement that a redesign of the major parameters that describe the current capital allocation system ought to be on the agenda. Disentangling the complex web of the many tiers of the banking system, shadow finance, exchange arrangements and the exchange rate – monetary policy regime is no simple matter. It is not just that capital is too cheap for certain large firms. Household savers are poorly remunerated as a consequence of historically regulated deposit rates. A lack of financial market development and exchange arrangements that disallow personal outward portfolio flows provides a limited menu of alternative investment options. Small, private firms often pay too much for their capital. Chinese exporters are advantaged by the competitive exchange rate, thereby raising export orientation, while importers are disadvantaged by it, which lowers domestic absorption.

As in the areas of energy and externality price reform, there has already been much activity in the field of financial liberalisation. Greater flexibility in setting deposit and lending rates has been introduced, although they are not yet fully free. The domestic bond market has been encouraged as an alternative source of both private and public financing. Loan securitisation has been encouraged. Exchange rate flexibility has been increased progressively after the peg to the US dollar was abandoned in 2005; reserve accumulation has levelled out; the supply of RMB now available outside the Mainland has increased rapidly as part of the trade settlement program, the centrepiece of the internationalisation initiative; the Qualified Foreign Institutional Investor (QFII) program, the Qualified Domestic Institutional Investor (QDII) program and a new Renminbi

QFII program have been revamped or instituted; and, outward flows of direct investment have continued to enjoy policy sponsorship. Furthermore, since the middle of 2012, the People's Bank of China (PBoC) has increasingly relied upon its open market operations to manage domestic liquidity and credit conditions, rather than the traditional administrative tools of required reserve ratios, window guidance and lending quotas. And, in a further move towards sophistication, rather than issuing or purchasing bills, reverse repurchase agreements dominated open market operations in 2012, when liquidity was being increased, while repurchase agreements have been used in 2013 so far to keep liquidity from expanding too quickly.

All of this activity points in the right direction. Yet, moving more swiftly on interest rate liberalisation, particularly with regard to deposit rates, would be a welcome move. An unintended consequence of the slow movement towards deregulation of interest rates has been the rapid growth of off balance sheet activity by the banks and a rise in the market share of non-banks in total credit supply. While such developments are desirable as part of an effort to deepen domestic financial markets, extraordinary growth in lightly regulated areas of the financial system unavoidably comes with heightened systemic risks.

Moving on to the monetary policy – foreign exchange nexus, in concert with the moves to increase the power of market forces in setting the domestic cost of capital, exchange rate flexibility has increased in material fashion since 2005, to the extent that the currency is an accepted element of the counter cyclical toolkit. While the daily volatility of the currency within the present band of plus-minus one per cent remains low, there have been official statements that a further widening of the band is just a matter of time. To quote People's Bank of China deputy governor Yi Gang directly, who spoke at an International Monetary Fund meeting in Washington DC on April 18, 2013:

Last year we increased the band for the exchange rate from 0.5 per cent to one per cent. I think in the near future we'll increase the floating band even further. ...

In China, we all do this kind of reform in a gradual manner. The direction is clear (quoted in *People's Daily* online 2013).

The desire to maintain a gradual approach to exchange rate flexibility emanates from China's structural legacies, the most obvious of which in this context is its high degree of export orientation, and the psychological difficulty of changing a winning formula. The success of China's gradual approach to financial reform through its transition era has been rightly celebrated. Yet when a new model is required, rather than a marginal evolution of business as usual, a bolder strategy is perhaps more appropriate.

It is possible to infer a relationship between macroeconomic stability, GDP per capita and financial reform in developing economies. Our abstract conception of this relationship is depicted in Figure 5.4. We have refrained from using actual values on the GDP per capita axis, as the precise point at which these hypothesised curves cross is unknowable, and may vary considerably based on the strategy individual economies take towards its financial system in the context of its industrialisation. That said, recalling the initial discussion and peer review of China's industrialisation path and mode, in this framework it seems reasonable to pursue a gradual approach to financial reforms at a GDP per capita level of \$2,000. At \$8,000, however, the implicit cost-benefit analysis of that strategy, where macroeconomic stability is the ultimate objective, will be less clear cut. Cognisant as we are of the wisdom of the State Council, that 'deepening ... reform is a systematic project that is arduous and complicated ... There is no way to accomplish it overnight' (Xinhua News 2013a), which are especially relevant sentiments regarding financial matters, we respectfully submit that the China of today, in search of a new model, cannot be far from the crossover point in Figure 5.4, if it is not already there.

Deepening financial deregulation cuts across the three reform categories that we put forward above. It would tackle specific distortions that create rents and skew resource allocation (the low cost of capital for certain firms and industries), it would address asymmetric opportunities that lead to and inflame imbalances (improve entry conditions to boost competition, improve access to finance for private firms and households), and work to minimise macroeconomic risks, and enhance macroeconomic benefits, in a more general way (reducing systemic risk through increasing the market based allocation of capital).

Turning now to labour, the basic wages of migrant workers have been increasing rapidly in recent years, which is a joint consequence of the demographic tightening of the labour market and a policy focus on raising incomes. Historically, wage rises for this group may have been as little as half the rate of increase of the wages of other workers (Huang and Tao: appendix: 27). They remain, however, an underprivileged group in a number of key ways:

1. access to public services in their place of residence for themselves and their families, rather than in their place of registration
2. access to social security in their place of residence, rather than in their place of registration
3. access to equivalent non-wage working conditions as urban residents.

Figure 5.4 The relationship between macroeconomic stability, GDP per capita and financial reform in developing economies

Source: Authors' own conception.

Bringing about such access will do much to optimise the opportunities presented by current and future urbanisation. The increase in consumption that such optimisation implies, with an equivalent decline in savings rates, will raise domestic absorption, cushion the impact of excess capacity in industry and accommodate a re-orientation towards domestic demand rather than foreign sales. Like the financial reform question, the migrant labour question cuts across many fundamental policy areas. And also like the financial reform question, bringing about the access regime depicted above will feature initiatives that fit into each of three categories above—tackle specific distortions (the low non-wage costs borne by firms employing migrants), it would address asymmetric opportunities that lead to and inflame imbalances (improve quality and quantity of education and health care), and work to minimise macroeconomic risks, and enhance macroeconomic benefits, in a more general way (providing the demand cushion for a re-orientation towards domestic sales, while helping to absorb excess industrial capacity). It is here that the ultimate complementarity of the twin goals of reducing the characteristic 'over-industrialisation' and optimising the benefits of urbanisation becomes extremely clear.

Employers are able to avoid considerable non-wage costs when they employ migrant workers rather than registered urban residents. These costs include social security contributions; unemployment, injury and health insurance; and,

housing and maternity benefits. This is essentially a transfer towards employers and away from the household sector, which sponsors capital accumulation over consumption. It is also a competitiveness issue, suppressing costs for Chinese labour-intensive manufacturing firms in the traded sector. Universal labour laws that do not recognise the *hukou* taxonomy will bring about an immediate and permanent increase in the labour share of income at the expense of excess profits.

Furthermore, it is difficult for most rural migrants to achieve urban resident status, with all the advantages (or lack of disadvantages) that this bestows in terms of access to quality and quantity of education and health services. The qualifying points systems that prevail in key destination provinces, such as Guangdong, are weighted against rural migrants. These systems are biased against poorly educated, low skill workers, who comprise the majority of the migrant labour force (OECD 2013: 97). China's average years of schooling at the \$2,000 GDP per head levels was similar to both Japan and South Korea, but it has slipped behind them at the \$8,000 per head threshold (Figures 5.2a and 5.2b). And, as the quality of that education is regionally variable, and affected by *hukou* status (OECD 2013: 91), then perhaps China is further behind than the raw figure suggests. This raises a further question about the adaptability of the current work force to a new model that is focused less on heavy industry and more on the consumption of services.

Watson's (2012) call for an integrated, centrally administered and funded and portable pension system available to all Chinese citizens is an appropriate template for social security reform. It is an obvious inefficiency in China's fiscal system that the national government has effectively centralised taxation revenues, but that expenditure responsibilities have not been transferred in lockstep.

The transition to a new model that de-emphasises manufacturing, investment and export sales and re-emphasises domestic household consumption cannot be brought about without fiscal reform. Indeed, fiscal policy is the key weapon at any government's disposal for altering the relative prices of productive factors and the ultimate distribution of national income among key sectors. One example is the preferential treatment of state-owned enterprises (SOEs) in terms of their dividend payments. The government can and should demand a higher rate of dividend payments from SOEs and redeploy the funds to accommodate the migrant welfare reforms considered above. The recently issued State Council guidelines for income redistribution set out such a policy. In a period when factor distortions that disproportionately benefit large, centrally controlled SOEs remain in place, it makes sense to redistribute their excess profits in a structurally beneficial way, rather than allowing further inefficient capital accumulation in the commanding heights. Competition policy can also

be brought to bear in this regard. Policies that boost competition in services sectors through foreign investment and those that constrain oligopoly pricing could have considerable benefits in rebalancing the growth model (Tyers 2012).

Another relevant aspect of China's historical path is the infrastructure–urbanisation nexus. In the peer review we noted that our infrastructure proxy—the length of rail line open scaled by land area—implied that China may be over-industrialised, but it is not without infrastructure deficits. Looking more broadly at the infrastructure space, annual logistics costs were equivalent to 18.1 per cent of GDP in 2012, compared to approximately ten per cent in the United States.³ Regarding mass urban transit systems, the OECD argues that 'A considerable deficit in provision needs to be overcome. In the ten largest cities, the average rail density per square kilometre is only one quarter that in the major urban areas outside of mainland China and the density per one million people is only one fifth' (2013: 74). In terms of end-to-end international trade logistics, China ranks 26th worldwide in the World Bank's Logistics Performance Index (World Bank 2012), ranking around 20 per cent less efficient than the frontier economies in the sample. Only 74 per cent of urban Chinese presently have access to sanitation, according to World Bank data (World Bank 2013). Against this evidence, it is not difficult to envisage the share of capital accumulation going into infrastructure rising, as China seeks to optimise its urbanisation opportunity, with the share going towards manufacturing capacity—particularly of the energy intensive and/or export oriented varieties—declining. Allocating investment to areas where the country continues to have a capital stock deficit, and reducing the emphasis on areas where capacity is already ample or excessive, will increase the efficiency of capital across the economy.

A Political Economic Comment

All of the above policy proposals, both specific and general, have been normative in nature. Our recommendations do not take account of the likely resistance of vested interests within the Chinese system. Entrenched rent seekers—or distributional coalitions as Olson (1982) termed them—do not have a history of stepping gracefully aside when their privileges are attacked. It would be naive to ignore this possibility in China. Indeed, the current administration has not just inherited an expenditure and income structure, it has inherited a structure of interests that have benefited from the historical model that will

3 The Chinese figure is calculated using data sourced from the CEIC data company. The figure for the United States is a personal communication from Access Asia, a Shanghai-based consultant to multinational retailers.

seek to defend their accumulated gains and to retain their privileges. The new leadership recognises this challenge is a considerable one over and above the need to install a new growth model. Returning again to the State Council's own words: 'deepening the income distribution reform is a systematic project that is arduous and complicated and *concerns the reallocation of various interests*' (Xinhua News 2013a, authors' italics).

Here again, a number of initiatives have been instituted to address certain issues in the rent seeking field. Symbolic moves—'austerity begins at home'-style policies, which have already been announced, include the capping of executive remuneration for state-appointed positions in SOEs, and income growth for executives must be slower than for rank-and-file employees; existing requirements for officials to report their income and assets will be implemented more strictly; the use of public funds for entertainment, automobile purchases and international travel will now be strictly monitored (anecdotal evidence indicates that the austerity required of officials over the Spring Festival in February 2013 reportedly led to substantially reduced turnover in high end restaurants); grassroots civil servants and those in underprivileged and remote locations will have their remuneration increased at higher rates than senior and better located state employees; and, cross-referencing of SOE average salaries across different sectors, with an aim of narrowing existing wage gaps; and a freezing of government staffing levels and a progressive reduction in the number of senior positions (Xinhua News 2013c).

Recently announced policy parameters with the potential to cut deep into current sources of imbalance and inequity are as follows:

1. Demanding that the proceeds from the use and sale of state resources—for example land, seas, water, minerals, forests—must be used for the provision of public services.
2. Reforms to the taxation of property, notably the extension of the current experimental holdings taxes nationwide.
3. Dividend reforms for SOEs (increasing their payout ratio to the state by five percentage points by 2015) and listed companies (Xinhua News 2013c).

These three areas are vital for the deepening of reform and shifting the economy towards a new model that is more sustainable and equitable. Our comment is, however, that there is a large gap here: competition policy. While redistribution of rents is a useful transitional position, a long-term solution must look to minimise the rents themselves. The discussion of the previous section considered the policy options for tackling the factor market distortions that generate rents. Undue market power is another distortion that redistributes

income to domestic firms in oligopoly sectors, and away from households, the government, and firms paying inflated prices for inputs; and, foreign firms that lose market share to such firms at home and in third markets.

The fact that the leadership is clearly not complacent on this front gives us confidence that the promising policy framework that is presently emerging will be progressively carried to its logical conclusion with resolve. The initial challenge in this regard will come with the next cyclical downturn, when the new model of growth is not yet firmly established and the temptation to mobilise demand in well-established, structurally negative ways will be strong (McKay 2011). While Li's sentiment on this future dilemma has already been quoted above, it is worth reviewing again:

'While effectively coping with short-term problems and maintaining reasonable growth, more efforts should be made to improve the quality and benefits of development, with a focus on promoting economic restructuring and upgrading, expanding employment and increasing people's incomes', he said.

'If interim measures have to be carried out, they should not set up barriers for promoting market-oriented reform and development in the future', he said. (Xinhua 2013b, authors' italics)

Conclusions

This chapter began by illustrating that China's economic structure can be characterised as both over-industrialised and under-urbanised relative to its level of income per head, while maintaining a high degree of export orientation for such a large economy. This discussion was framed by the experience of a peer group of economies that have also succeeded in quadrupling their living standards from \$2,000 GDP per head to \$8,000 GDP per head in the post-Second World War period.

Some aspects of China's historical path and the resultant contemporary structure were positioned as an impediment to sustaining growth in aggregate living standards in an environmentally conscious way, while simultaneously promoting equality of income and opportunity. Others were seen as advantageous for the pursuit of these basic national goals.

We then proceeded to outline desirable changes in policy to accommodate a new model, alongside a discussion of initiatives already put in place by the administration to that end. This discussion was initially conducted within the context of a direct effort to address specific factor market distortions, but was later broadened to macroeconomic policy writ large. Our recommendations

were to deepen and accelerate financial reform—domestic and international—in a holistic way; move swiftly on wholesale *hukou* reform; continue with the current momentum towards market-based pricing of energy and negative externalities; prioritise infrastructure investment over industrial capacity; and, address fundamental long-run fiscal questions to accommodate the desired reallocation of resources across the economy. We concluded this discussion optimistically, given our view that the superordinate goals of China's next transition—reducing 'over-industrialisation', optimising urbanisation and emphasising domestic absorption over foreign sales—are ultimately complementary.

At this point we introduced a caveat: that the many facets of path dependence present a material *prima facie* political-economic constraint on the Chinese leadership's absolute freedom of choice and action. We applaud the present direction of the policy regime and the objectives of the administration are sound. Yet, we believe that the absence of a well-defined approach to competition policy is a clear shortfall in the existing framework put forward by the new leadership. Further, we noted that the next cyclical downturn will be a strong test of the stoicism of the reformers.

Finally, the fact that the leadership is clearly not complacent gives us confidence that the required reforms will be carried to their conclusion with resolve, if not necessarily with alacrity. There is much to recommend in the policy contours that have already emerged in pursuit of those inherently complementary goals. Yet inside those contours, a political economic battle must still be fought. Reducing 'over-industrialisation', optimising urbanisation and emphasising domestic absorption over foreign sales are necessary conditions for a successful transition of China's growth model.

The board is set. The pieces are moving.⁴

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4 With apologies to the scriptwriters of *The Lord of the Rings* for borrowing Gandalf's immortal phrase.

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