Progress and headwinds in the third stage of China's reform

***Michel Aglietta*[1]**

For the conference on regulation

10-12 June 2015

Session on China

Abstract

Chinese reform is an endogenous process that feeds on its own contradictions and creates its own way through stages interspersed by crises that are part of the reform. The present contradictions are defined in the distortions of factor prices that entail all the vulnerabilities that have been pinpointed ad nauseam, from income inequalities to corruption excesses, from overcapacities to environment degradation.

However the incipient new stage of reform goes much deeper than the economy. The Directives paper issued by the central committee of CCP at its third plenum in November 2013 is a theoretical compendium for a strategic view of the reform, based upon the principle of separation between market and state under the unifying predominance of the Law. The paper analyzes the directives of the third plenum that defines an impressive outline of the next 20-year reform. The three basic objectives are inclusiveness, protection of rights and improving economic efficiency

The political feasibility of the reform depends on the sequencing in implementation, able to yield early benefits to legitimate more contentious policy decisions in the future. Labor market developments entail major gains in bargaining power to the workers. The government is accompanying the process in expanding a basic social safety net, prodding a catching-up in low wages, enforcing labor contracts and introducing collective bargaining. Capital market reform is enhanced by the urgency of dealing with non-performing loans held in SOEs and credit platforms guaranteed by local governments. Fostering bond markets, encouraging private banks to finance SMEs, building a strong prudential framework to deregulate interest rates and moving wisely to Renminbi convertibility in the new Shanghai free trade area, are consistent moves to rebalance the financial system. To reshape it in view of financing investment climate for reducing GHG emissions and other pollutions, a Green Finance Task Force has been set up to create new financial institutions and instruments backed by a strong legal framework.

In involving deep social changes, the reform entails risks. Reforming rural land and natural resource prices will be difficult. The land-use rights of farmers will be secured under the law and made transferable in rural land markets. Prices of fuel, water, electricity and carbon will be

---

[1] Michel Aglietta is emeritus professor (university of Paris West) and scientific advisor in Cepii and France Stratégie.

progressively upgraded to their social marginal costs within an integrated urban rural model to accommodate 350million migrants over the next 20 years. Combining new smart cities and social inclusiveness will be spurred by relaxing the hukou system and extending urban social rights to migrants. It will require tough political decisions in fiscal sharing amongst local governments and in rebalancing the tax system towards more progressive direct taxes.

Moving to low-carbon economy is critical to drive the country on a sustainable growth path. Progress has already occurred on four areas: controlling GHG emissions, adjusting industrial structure to services, improving energy mix and making energy use more efficient. To support the transition to the new industrial base, innovation is key. The new urban model is the framework in which investment climate must develop. The shift in economic structure away from heavy industries will be the first contributor to coal-use abatement. Tougher pollution and energy-efficiency standards follow, as well as the pricing of carbon. To implement such sweeping reforms the main China's advantage is political. China has a unified political force, a strong leadership and an elite that understands that the lead on climate issues will help developing new tech industries.

JEL: D62, D63, E20, Q48, R14

Table of contents

I. Introduction: the long-run view

In November 2013, the central committee of CPC (Communist Party of China) issued a Directives Paper at its third plenum. The Paper is a long-term strategic compendium on China's reform agenda, based on the principle of separation between market and state under the unifying predominance of the Law.

The Directives Paper constitutes an ambitious reform plan for the next 20 years. The directives reassert the overriding goal of the reform since its start in late 1970s: *founding a socialist market economy on the basis of the decoupling of the State from the market*. The Directives define the socialist market economy as a moderately prosperous society in harmony with nature. Under this heading they provide a roadmap for the party leadership, the whole structure of government and the associated bureaucracy, and society at large. The roadmap constitutes an ambitious reform plan for the next 20 years

The Directives have not sprung in vacuum from the mind of a charismatic leader, though Xi Jinping is a strong leader that has emerged from the consensus reached in party politics that was the outcome reached in the early years of the present decade.

Indeed the reform is endogenous. It is *the joint transformation of economic structures and institutions*. It is global, pluralistic, and gradual[2]. It feeds on its own contradictions. It is a self-perpetuating process that goes through stages of progress, interspersed with crises where the political monitoring is at stake. In those critical crises, the objectives and the mode of governance are restated under the new leadership that has won the argument inside the Party. The process is illustrated on figure 1.

Prescriptions are made around three basic objectives, which are the pillars of the reform in the new era that is in its incipient stage.

The first is *inclusiveness.* For the political regime it means that all citizens improve their mode of living, so that they have a common interest to respect the institutions. Inclusiveness involves not only increasing primary real incomes, but also reducing the range of inequalities in disposable income. Furthermore, no inclusiveness can be achieved without a sustainable growth regime, meaning a new urban model and sweeping energy transition.

The second is the *protection of rights,* property rights for the well-functioning of the market, but also legal and political rights to foster real democracy in civil society. The Directives insist on the question of improving rights in all domains of society. It implies universal basic social welfare, eradication of the excesses of corruption, administrative waste and abuses of power.

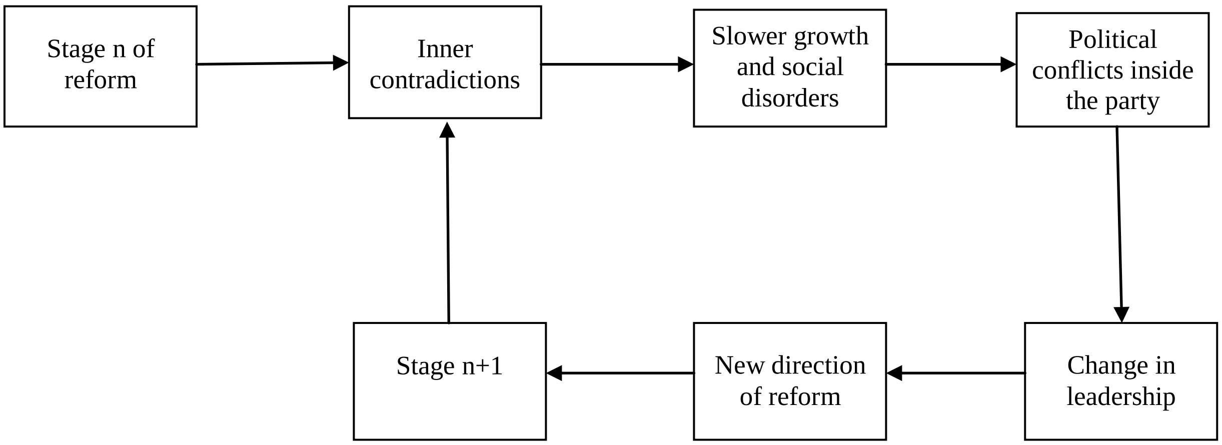
The third is the *improvement in economic efficiency*, which is the means to achieve the two higher objectives. A strategic judgment is that enough growth has to be maintained to secure full employment in urban areas and become more qualitative to match inclusiveness and sustainability.

The political feasibility of the reform depends on the sequencing in implementation, able to yield early benefits to legitimate more contentious policy decisions in the future.

---

[2] For a comprehensive understanding of the reform in its early years, see G. Chow, *China's economic transformation,* Maiden MA, Blackwell Publishing, 2002

Figure 1. The Yin/Yang process of Chinese reform



The next sections will explore the roadmap. In section II the contradictions to be overcome will be pointed out and the meaning of the decoupling between State and market will be defined. In section III a short outlook of what was already achieved and what is the present economic situation will be provided. Section IV will analyze the main structural policies, their consistency and the conditions of their success. Finally section V will be conclusive in venturing into the more assertive position of China in the world.

II. The Directives in the longer-term reform process

The Directives have fostered Decisions implemented under the leadership of the State Council. They shape the third stage of a reform agenda that has started after the comeback of Deng Xiaoping to power in 1978. Without entering details, let us sum up the stylized facts of the first two stages of the reform (table 1). A reform stage is a growth regime that achieves goals and jointly generates contradictions leading to a systemic crisis. The crisis provokes a political struggle within the Party that overhauls the leadership and redefines the principles of policies aiming at moving over the contradictions. In so doing the political process outlines a new growth regime.

1. The nature of the growth regimes from 1979 to 2010

After the tragic repression of the Tian Anmen Square event, the party had to regain authority and legitimacy. A powerful conservative faction recommended the backward return to overall central planning. The progressive avant-garde looked destabilized and lacking of a new orientation. Debates raged in the shadows of the inner circles of the party until Deng toured the South East of the country in the spring of 1992. Such was Deng's authority in the party that this visit was a turning point. He decided to push the reform forward in generalizing the special industrial zones, to welcome foreign FDI therein, to open manufacturing to international competition and to deregulate industrial prices progressively.

Table 1. A bird's eye view of the first two stages

Stage 1: 1979-1989		Stage 2: 1993-2010	
Achievements	**Contradictions**	**Achievements**	**Contradictions**
- Dual track in agriculture: markets/planned quotas and increase in rural income - Commercial responsibility of firms - Subsidies to urban workers	- Collapse of State budget and central government control - Collusion of local governments and SOEs - Explosion of directed credit and NPLs - Galloping inflation and fall in real wages	- Demo dividend - Export-led growth, FDI and process trade - Capital accumulation in heavy industries - Centralization of fiscal resources - Privatization of small SOEs - Stabilizing monetary policy and resolution of banking crisis - Privatization of urban land and residential building expansion - Fast growth of GDP and real income	- Discriminations against migrants: subsistence wage +hukou - Massive transfers of households to SOEs via the financial system - High energy and carbon intensity, environmental damage - Widening inequalities: rural/urban and income structure - Massive and widespread corruption - Misallocation of capital

The second stage of reform was highly successful in setting up an industrial base that has propelled China as the second economic powerhouse in the world. Trade flows to and from China impacted heavily macroeconomic variables in primary resource producers and Eastern Asian countries. However distortions in the prices of the factors of production[3] nurtured huge inequalities in the income structure, a dramatic increase in real estate prices and big overcapacities in heavy industries. Therefore, along with its outstanding performance in growth and trade expansion, the legacy of stage 2 was a knot of contradictions in the growth regime. They have been magnified by the aftermath of the financial crisis. In accordance with G20 recommendation, the government undertook a massive stimulation to avoid a collapse in growth. It succeeded but magnified all the inherited distortions. Table 2 pinpoints the nature, causes and consequences of distortions that call for a new mode of regulation.

[3] Y. Huang, "China's great ascendancy and structural risks : consequences of asymmetric market liberalization", *Asian-Pacific economic literature*, vol.24, n°1, November 2010 p.65-85.

Table 2. Distortions in the prices of production factors

Type of factor	Nature of distortion	Causes	Consequences
Labor	- Urban wage of migrants slightly > rural income→ SOEs and subcontractors capture productivity gains	- Rural labor surplus - Social rights of migrants denied - No labor contract in private sector	- Wage share ↓ - Income inequalities↑ - Weak bargaining power of labor and lack of human capital
Capital	- Base real interest rate << growth rate → cost of capital low for SOEs and high for SMEs	- Max growth needs very high invest rate biased toward SOEs in heavy industries	- Productive structure distorted→ services undeveloped - Household saving trapped in low-yield deposits
Urban land	Land market polarized: prices low for industry, high for real estate	- Land valued captured by local governments to substitute for insufficient fiscal resources: off-budget +value and collateral of credit	High land price bars purchase of housing by low-middle income classes
Rural land	- Farmers expropriated: land seized by local governments		Arable→ constructible land→ urban sprawl + brake to rural migration
Energy	- Heavily <u>subsidized</u> energy	- Extraction rights granted at very low costs	- Energy intensity of production much too high
Carbon	- Price inexistent or very low	- externalities by degrading environment	- Pollution, water scarcity and soil deterioration

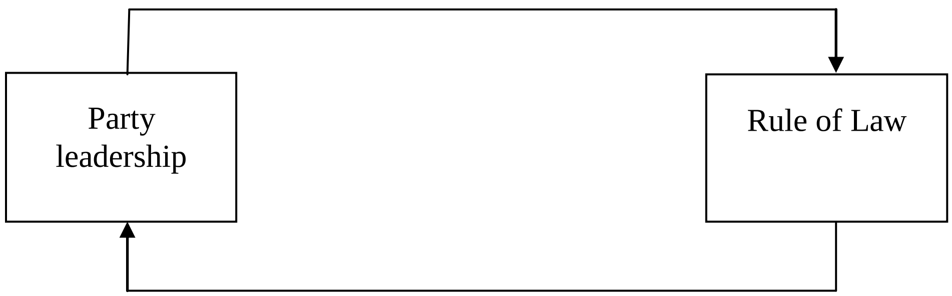
In November 2012 in the five-year session of the party Congress, a change of leadership (due every 10years) occurred. It renewed the central committee and promoted a new strong leadership dedicated to reform, led by President Xi Jiping and Prime Minister Li Keqiang. The monitoring core of the central government (State Council) lost no time, since it presented a comprehensive reform agenda for approval by the central committee one year later[4].

[4] The substance of structural changes advocated in the Directives was prepared in a powerful work undertaken by the development research center, a think tank close to the State Council, in collaboration with the World Bank. Elaborated and written in 2012, the report was published in 2013 under the heading: "*China 2030. Building a modern, harmonious and creative society.*", World Bank, 2013

2. The principles embodied in the Directives

To develop so deep a reform as encapsulated in the Directives, political legitimacy matters decisively. How can China's constitutional order achieve it? What does the socialist rule of law with Chinese characteristics mean[5]? The plenum restated two basic norms that together make the Chinese concept of sovereignty. First, the party is the most fundamental guarantor for the socialist rule of law. Second, the party must govern according to the law. This is a roundabout process (figure 2). It makes sense under the overall predominance of an ethical foundation of sovereignty that runs deep into Confucian political philosophy: the party must govern for the welfare of the people according to the principles codified in the law. Putting people first and legislating for the sake of the people make the basis of good government.

Figure 2. Interdependence between party leadership and rule of law



The Party must enforce the rule of Law in legislating for the sake of the people. The rule of Law makes party leadership legitimate to the people. Therefore governing according to the law requires the party to run the administration so as to align the bureaucrats on the public interest as stated in the Law. Major tasks ensue to strengthen the people's sense of fairness and raise judicial credibility, so that the spirit of the law pervades the whole society.

Judicial powers and enforcement powers must be separated. For the party to exert leadership according to the law, strong mechanisms of supervision must be established within the party to search and prosecute legal violations and unlawful use of power. The relentless anti-corruption campaign shows that Xi's leadership means business.

The separation between judiciary and administrative powers is thus the gist of the political side of the reform. To bar arbitrariness and to impede administrative interference with judicial decisions, protection mechanisms will be established for judicial personnel carrying out their statutory duties. Judicial activities will be standardized and the lawfulness of judicial acts will be supervised under recording, reporting and responsibility investigation systems. Public legal service systems must cover urban and rural population for assistance and judicial relief.

Therefore the Law will be what makes the three types of societal organizations, State, market and civil society, consistent. The predominance of the Law is the fulcrum to guarantee market freedom and autonomy of a vivid civil society. It will foster an enlarged role for local formal

[5] R.Peerenboorn, « so what exactly is socialist rule of law with Chinese characteristics?", *China Economic Quarterly*, December 2014, December 2014, pp.47-50

democracy and more importantly real democracy through social networks in intervening in concrete decisions impinging upon everyday life. In forcefully spelling out these principles, the Directives are announcing a political and social upheaval.

The State will behave as an equity owner along others, while the capital of SOEs has been opened to private shareholders. Multiple forms of properties will be welcome for the large diversity of enterprises in China: public, private, and cooperative. Public enterprises will be subjected to the performance criteria of competitive while market structures are not conducive to natural monopoly, to well-defined and publicized obligations otherwise.

In economic terms the market will be responsible for the allocation of capital whenever it is the most effective institution to do it. In separating the State from the market and defining State attribution over the economy, the implementation of the directives will markedly improve the efficiency of the State. Its attributions will still be huge. It will regulate the macro economy with the help of the compass of strategic long-run planning. It will take care of the stability of the financial system and produce the public goods in the respect of the Law. Strategic planning will be grounded on qualitative criteria made imperative to local governments and replacing maximum GDP growth. The challenge of strategic planning is first and foremost the joint rural and urban development to achieve ecological civilization. Because 300 million people will migrate to existing or entirely new cities until 2030, planning for creating and restructuring cities compatible with environment-friendly models is the overriding objective of long-run planning. Projected economic reforms can be understood under this heading.

III. Economic transition in the making: perilous adjustment

Western opinion, as broadcasted by the media, is schizophrenic about Chinese policy. On the one hand it is happy to pinpoint that China suffers from huge overinvestment and under consumption, on the other hand it laments that growth is slowing down and routinely predicates an imminent hard landing. Landing to what? Presumably a restructuring of the economy toward less capital accumulation and more consumption. It leads to a growth regime less intensive in capital and therefore a progressively declining growth path. Because the transition must smooth out the slowdown in growth and engineer structural changes to achieve a better quality of growth, while curing the financial imbalances from the unbalanced high growth regime, it needs clever policies indeed. Up to now they have been remarkably successful.

Over investment entails inefficiency in production that leads to under consumption. The assertion is true but deserves qualification. The share of consumption in GDP slumped to 38%. However the national accounts underestimates consumption for several reasons. In correcting indentified bias on the base of surveys, academic studies run in CASS found a share of 43 to 45% in 2010, not far from the trajectory of Asian countries at the same stage of development that preceded China. Had the share of consumption been what it was 30 years ago, the real income level of the Chinese population would still be very low. Is there global overinvestment in China? The investment ratio was 48% of GDP in 2012.However the capital per worker is ¼ of Korea's and 1/5 of US capital per worker.

What is at stake are sector overcapacities directly related to the price distortions depicted on table 2. In economic terms the logic of the reform in its third stage is the change in incentives, regulations and fiscal policy to eradicate factor price distortions. China has built a large middle class from past successes on which it can take stock to develop domestic demand and move to consumer-led economy.

1. The macroeconomics of new growth strategy

Let us start from Harrod's growth accounting:

Growth rate= $\Delta Y/Y=(\Delta K/Y)/(\Delta K/\Delta Y)$=(Invest/output)/ICOR

ICOR=Incremental capital per unit of output is the reverse of the marginal productivity of capital. The lower is ICOR, the higher the efficiency of investment. Therefore the decline in growth rate due to reducing the share of investment can be mitigated by a diminution of ICOR, i.e. by an increase in productivity.

There are four means to reduce ICOR; changes in production structure to sectors with lower capital requirements; allocating capital more efficiently in each industry; promoting energy efficiency in each industry; increasing labor productivity via investing in skills and upward social mobility. One effective process is the shift to services where ICOR is 40% lower than in aggregate. Presently ICOR is very high in China, around 5 compared to 2-3 in developed countries. To bring back ICOR to 4 at constant growth rate net overall investment must decline 30%. The shift to services can do it at declining growth rates because investment requirement is much lower than in heavy industries. Service sectors being much more labor intensive the transition can happen without disruptive unemployment.

The shift to services can rest on the former buildup of the middle class. Looking at labor markets, the third stage of reform has already yielded significant results. The recent rate of wage growth has been high and social benefits have improved. Increased wages should result in consumer demand for better services. It should also lift the prices of non-traded related to traded goods, raising the profit margin of firms in the services and consumer goods sectors. This might in turn generate demand for labor to substitute for the reduction in production capacity in oversized industrial sectors.

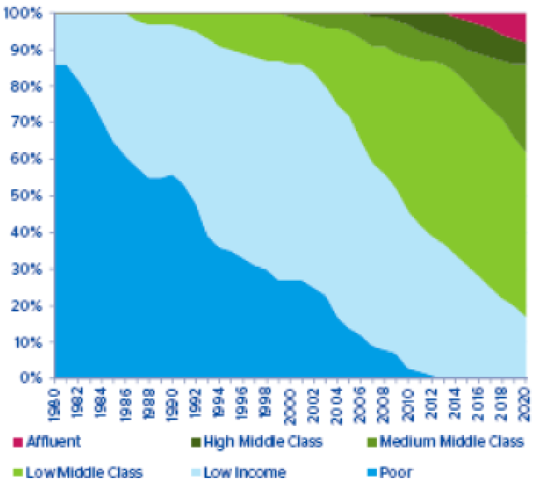
An emerging middle class in fast-track mode is underway. In the 30 years since 1980, the number of absolute poor (less than \$1,000 per year) has declined steadily. The dramatic changes after 2003 (resolution of the severe banking crisis) produced a large increase in the size of the low-middle class (ranging from \$5,000 to \$15,000 per year). In the next 5-year plan (2016-2020) the higher middle class income categories are expected to rise substantially (figure 1).

The rise of the middle class is the most potent force to transform China's growth regime. In coming years, rising real income among the middle class should diversify the range of consumer goods and services towards products with higher income elasticity, boosting activity in skilled labor-intensive sectors.

The service sector has already become larger than manufacturing and more dynamic. It is bolstering the contribution of consumption in growth. Private consumption growth has contributed 4% of 7.8% GDP growth rate in 2012, 3.9% of 7.7% in 2013 and 5.7% out of 7.4% GDP growth in 2014. In share of GDP, the service sector accounted for 48.2% in 2014 against 42.6% for manufacturing. With the rebalancing, 13.2 million new urban jobs were created in 2014, an all-time high with a lower rate of growth.

An optimistic scenario could unfold on that basis. Higher earnings among a wider population could also reduce the informal economy and boost tax revenues to finance basic social welfare. Demand for better and higher education is likely to increase steadily. Greater education opportunities and higher levels of education could in turn enhance social cohesion and political stability through inclusiveness.

Figure 3. Population in China by range of GDP per capita
(% of total population)



Source: BBVA Research, Economic Watch. Eagles, January 2013, p.5.

2. Fighting the short-term headwinds

Strategic planning allows the central government to pursue the structural reforms set in the Directives while taking the stimulus initiatives to mitigate the impact to avert a sharp fall in output growth. Since the third stage started two years ago macroeconomic policy has succeeded in preserving the so-called soft landing to the "new normal". Table 3 depicts the base line scenario of the government.

Table 3. Main macroeconomic indicators

Items	2013	2014	2015 (forecast)
GDP (% y-o-y)	7.7	7.4	7.0
Inflation (% average)	2.6	2.0	1.7
Fiscal balance (% GDP)	-1.9	-1.8	-2.5
Current account (% GDP)	2.0	2.5	2.8
Policy rate (%)	6.0	5.6	4.6
Exchange rate (CNY/$)	6.05	6.21	6.15

Source: NBS.

The structural shift to services has permitted an orderly growth slowdown up to now without any negative impact on urban registered unemployment that has stood around 4.05-4.1% of urban labor force. This is the primary target of economic policy in the short run. It can smooth the transition, but it cannot alone ward off the headwinds accumulated from former excesses. Surging debt, the unraveling of the bubble in property markets and excess corporate production capacities are domestic risks that are magnified by external uncertainty in world markets. Shrinking foreign trade, capital outflows and deflation risks stifle the monetary transmission mechanism alike in developed countries. Indeed, in the spring of 2015 economic activity has gotten too sluggish to achieve the 7% growth target for this year. Consumption and urban investment growth are sloping downward in tandem. More easing measures will be taken ahead to achieve the target.

However, in this adverse financial environment, monetary easing is struggling to boost credit. More use of standard instruments, policy rate and required reserve ratios, might fail to provide the much- awaited stimulus to maintain the soft-landing profile. Despite 3 interest rate cuts in 6 months, deflationary pressures have persisted, so that the real interest rate on credit has actually increased. Therefore some measure of QE is in the pipeline. It shall not be done like in Anglo-Saxon countries where productive investment has not recovered and a severe productivity slowdown is jeopardizing the sustainability of the recovery. Even worse is the European record with long-delayed QE, deadly fiscal austerity in 2011-13, paralysis in political governance and total absence of any medium-term strategy.

To eschew this trap, the structural reforms implemented with NDRC monitoring and the macroeconomic policy stance of the PBoC must be combined under State Council leadership, so that the sequencing of reforms picks up the ones that can help economic activity in the short run to alleviate the pressure on monetary stimulation.

One of the dark spot is the debt of local governments inherited from insufficient direct sources of revenue that were magnified with the huge stimulation plan in 2009. Local governments resorted to rush into debt with the device of obscure credit vehicles themselves financed by bank credit. The central government decided to deal with the matter in depth. In 2014 a revised budget law was adopted by the National People's Assembly. It enacts that the central government will provide more funding and give new taxation powers to local government. Furthermore the revised budget law allows local government to issue municipal bonds subject to central approval in conformity with the objectives of the nation's plan. Meanwhile 1trillon Yuan of local government liabilities is being rescheduled with the support of bond issuance to get rid of the special vehicles, a brand of shadow banking. Moreover creating a bond market under NDRC monitoring helps reduce the excessive importance of banks in the financing of the economy, thus participating to the broader financial reform. To deepen the bond market beyond institutional investors, PBoC might incentivize banks to participate in accepting the bonds with NDRC certification as collateral for refinancing in the money market.

Beyond debt restructuring, the fiscal reform will be amplified in 2016 to solve the structural mismatch between the 85% share of public expenditures in charge of local governments and the 45% share of their revenues. The reform package will reduce local budget shortfalls decisively. The set of scheduled measures is comprehensive: expanding VAT to include services, instituting new resource and property taxes, introducing multi-year budgeting to manage debt prudently.

Another leeway can be found in higher social expenditures by central government to complement the rapid rise of consumption expenditure (8 to 9% annual average over 10 years). China's state is overly parsimonious in its social expenditures and also in overall expenditure since it amounts to 28% GDP against an average of 35% for other middle-income countries. The proportion of government spending to social services is too low. If it were to expand from 13 to 18% GDP by 2020, including the construction of social housing, it would provide the demand needed to achieve 7% growth in the end of the decade even if growth subsides to 6.5% for 2 years.

The weakness of SOE balance sheets in heavy industries is another worry. The ROA of private firms is roughly double of that of SOEs while their profit margins are similar. The reason can be found in asset turnover. Private firms generate more revenues from a given asset base because of redundant capacity in SOEs. Other firms with redundant capacities are real estate developers overloaded with unsold housing.

Overleveraged SOEs due to overcapacity are financially vulnerable when the ratio of their gross operating profit/scheduled flow of interest payment is <1. They get stressed whenever real interest rates rise with the weakening of inflation. It is the main reason why the PBoC pursues a low-interest rate policy despite its limited impact on new credit. However more is needed to alleviate the financial vulnerability. Overcapacities will be reduced by corporate restructuring: size reduction through consolidation, injection of private capital through mixed ownership, state ownership transferred to public financial holding companies with duty to reform corporate governance. PBoC and CBRC will spread and manage the process to avoid any large insolvency with potential to create systemic risk. They instruct commercial bank to roll over corporate debt but forbid them to extend net new credit to SOEs that have not reduced their overcapacities by a specified percentage depending on the magnitude of their vulnerability and the economic situation of their sectors of activity.

Finally the third domain of financial vulnerability is the real estate sector. This is a dual market because in tier-1 cities prices are still somewhat overvalued even if they have lately receded. In smaller cities a more severe slump in prices has been engineered by an oversupply of housing. In the medium term there are three reasons to conjecture a rise in equilibrium housing prices: the rise in income growth of the middle class because China will go on following the Asian model of catching up higher-income countries; increasing population density with ongoing urbanization, lower construction costs with innovation in material inputs and energy efficiency.

The government will keep restrictive financial measures against speculation to keep commercial housing affordable and continue boosting social housing. On the demand side, help will come from rural migration into cities that can be boosted by a progressive phasing out of *Hukou* cum extending urban social rights with migrants. On the supply side, the rehabilitation of unhealthy rural zone in megacities, the recognition of land-use right to farmers and the organization of markets to transfer those rights cum swap of rural construction land into farmland attached to land-use right transactions should be able to match supply and demand.

IV. Priorities for a sustainable growth path

As analyzed in section III, China has the political, financial and administrative resources to set the country on track to reach the ultimate finality in the present era: establishing an inclusive and ecological society. What are the economic transformations to get there? What are the priorities in strategic planning?

The challenge of strategic planning is first and foremost the joint rural and urban development to achieve ecological civilization. Because around 350 million people will migrate to existing or entirely new cities until 2035, planning for creating and restructuring cities compatible with environment-friendly models is the overriding objective of long-run planning. Projected economic reforms can be understood under this heading.

To get to this new urban China a sustained increase in total factor productivity (TFP) is the key. The migration to cities will contribute to the rise in labor productivity, since it is about 5 times higher in urban than in rural areas. The latter will be upgraded too because migrations will make it possible to concentrate land ownership leading to modern farming.

The other and crucial dimension of TFP increase is the productivity of capital. As already mentioned in section III, the uptrend in the share of services in GDP is a major determinant in enhancing the productivity of capital. Another one stems from industrial policy: improving energy efficiency, changing the mix of primary energy sources in the production of electricity and developing innovation systems.

1. The reform agenda for a new urban landscape in 2030[6].

Urban areas contributed most to the 10% average growth in 3 decades with cheap land, abundant labor and infrastructure investment. Urban population increased 500millions in the last 30 years. However urbanization is still incomplete quantitatively (300 to 350 mil will migrate in the next 20 years to reach the billion urbans) and qualitatively (the urban model was not that efficient in containing congestion and pollution costs). Concentration of high-end services is the most potent driver of TFP. There is much room for that process in China.

In 2012 migrant workers made up more than a third of the labor force. Their wages have increased substantially over time because they are better educated. However the ratio migrant/urban workers' wages has declined. Because of their dissatisfaction, many migrants do not settle permanently in cities with their families. The key reasons are administrative hurdles that are equivalent to a tax on migration. The *Hukou* system linked to entitlement for public services in cities discriminates against migrants; there is a lack of portability of social security rights and insufficient low-income housing.

On the rural side land is a common good but the right to land use are long-term lease. They should be guaranteed lawfully to farmers, allowing to sell or mortgage when they want to migrate. Instead the vagueness in allocating land use rights has allowed local governments to grab urban land for inadequate indemnities and capture windfall gains in selling the land to developers. The result has been urban sprawl and related nuisances because local authorities have incentives to expand cities instead of developing underused urban land, which would cost fiscal resources they do not have. As a result of inadequate property rights and distorted tax

[6] The most important contribution to the transformation of the urban model in China is the joint report by the Development Research Center of the State Council (DRC) and the World Bank, "*Urban China*", March 2014
Another one is Tom Miller, "*China's urban billion",* Asian Arguments, Zed Books, 2012.

allocation between levels of governments and territories, urban peripheries are fragmented because available land for conversion is not adjacent to the core cities.

Turning the trend is crucial to take advantage of agglomeration effects in the cities and to provide more land to agriculture by reconverting into crop and pasture land the constructed land abandoned by the migrants. A joint rural urban development can be organized in moving to circular economy, especially in the West where land is more plentiful.

The free rural urban migration will also be a powerful lever to reduce inequalities drastically, as Korea as done beforehand. The Hukou system has already been substantially relaxed after the State Council issued guidelines in 2011 for a gradual phasing out of the resident permit system. The main problem lies in the access to urban social services.

- ***Merging urban and rural social insurance schemes***

If the Rule of Law recognizes ownership rights of migrant candidates on the rural land they cultivate, the flow of migrants seeking permanent settlement in cities with their families will swell; so will the additional demand for social services. Without more fiscal resources for local governments or central government centralizing social security, former urban residents will feel a deterioration of the quality of public services and social tensions would rise.

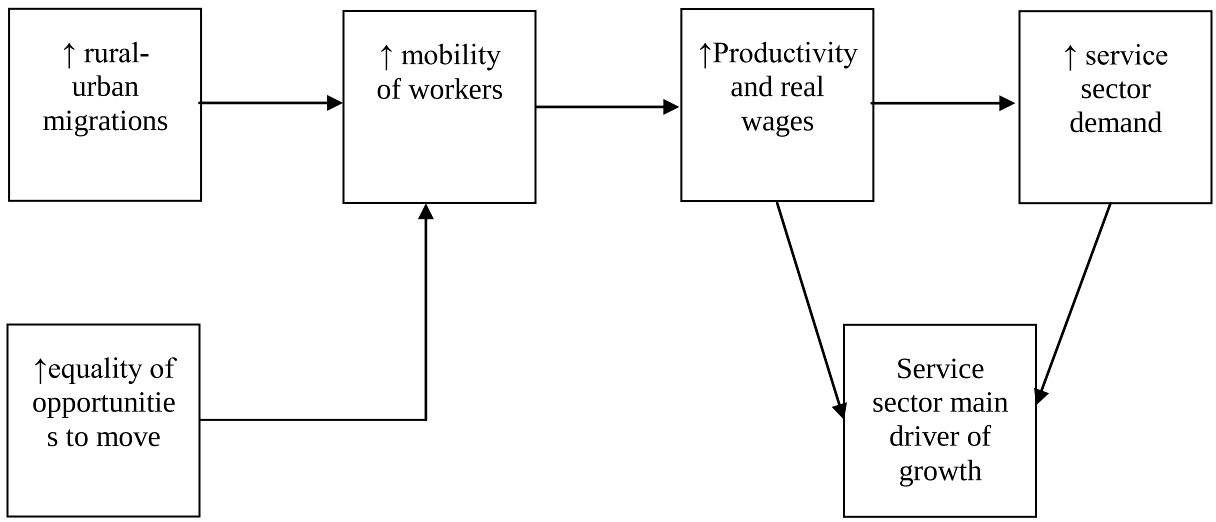
It means that the different components of reform are intertwined. Only the strong political will of the present party leadership and a competent monitoring of all aspects of strategic planning can overcome the hurdles. Furthermore the shortage of social housing must be eradicated over time by a long-term investment program. It must be integrated into city planning designed to build ahead of the potential flow of migrants, so that millions of new urbanites are welcomed into new urban districts instead of being piled up in congested old neighborhoods.

Much has already been done in expanding insurance systems and pension coverage and in investing in health services. International observations show that developing social insurance systems propels health-spending growth about twice as fast as GDP. However the majority of migrants are still enrolled in the rural insurance scheme, while the benefits are not portable. It forces migrants to advance the payment of health cares and get reimbursed at the rural conditions when they come back to their place of registration for holidays.

The Social Insurance law of 2011 has stipulated that rural and urban pension schemes must be merged. However it is far from being fully implemented, neither is the Labor Contract Law of 2009 in the private sector.

According to the joint report (op.cit. note 6), two intertwined splits, urban/rural and local urban hukou/migrants, undermine inclusiveness. Hukou and access to basic social services in cities must be reformed together. To achieve it, several brands of reform must be articulated: legal reform to provide farmers the full benefits of land-use rights, financial reform to create markets to trade those rights, fiscal reforms to supply the demand for social services that will be enhanced by higher labor mobility and unification in entitlements. The basic social services that must be equalized across China are: school attendance for migrant children, public health programs and basic medical care, incorporation of migrants in urban workers' pension systems, access to affordable housing. It will increase the fiscal cost by about 1.5% GDP. The joint *Hukou* reform and more equal access to public services will provide important economic advantages in redirecting the growth regime (figure 4).

Figure 4. Hukou reform and public services



Obviously China can afford it. But the government sources of revenue must be overhauled. Both the tax structure and the tax-sharing system must be reformed. The accountability of local governments to citizens must be enhanced by linking more local expenditures to local taxes levied on residents. The best local tax to provide a stable source of revenue is the property tax on housing. It will be an incentive to develop unused or underused land. In a transition period of several years it will not yield enough money to replace fully the windfall gains of land capture. It should be complemented by other local revenue, including the rise in prices of urban services that are extremely low: mass transit, water, waste water, electricity and gas. It should launch the process of adjusting the prices of those services to their social marginal cost, including the environmental impact of their use. All in all, local taxes of all kinds, after a progressive path to full capacity and duly compensation of lower-income people, might raise revenues of 2 to 5% of GDP according to the report.

The revenue-sharing system requires deep changes. Pensions for portability and basic social security for equity in a reasonably prosperous society should be transferred to the central government and a revenue-sharing mechanism instituted. To mitigate unequal effects of the very inefficient present transfer system, the central government has created a patchwork of specific grants to local governments and are nests of corruption. Too complex and intricate to be responsive to change, this opportunistic system undermines the accountability and the autonomy of local governments. In opposition to this ad hoc system, the revenue-sharing mechanism should redistribute tax revenues between subnational governments according to objective measures of needs. VAT should be shared according to places of consumption. High-income provinces would have the opportunity to replace their lost revenues with higher local taxes.

- ***Land reform and management***

Land reform is the cornerstone of the urban model upon which sustainable development can thrive. It is an opportunity not to be missed. Indeed urban design while being implemented builds very long-time infrastructures that create path dependency with respect to land use, transportation and resource allocation. Poorly-planned cities, like Los Angeles or Atlanta, are cities shaped on the lines of the post-war American model: urban sprawl induced by unbound domination of individual preference for car and suburban house. Ignorance of space constraints and environmental externalities magnify environmental costs, air pollution and congestion.

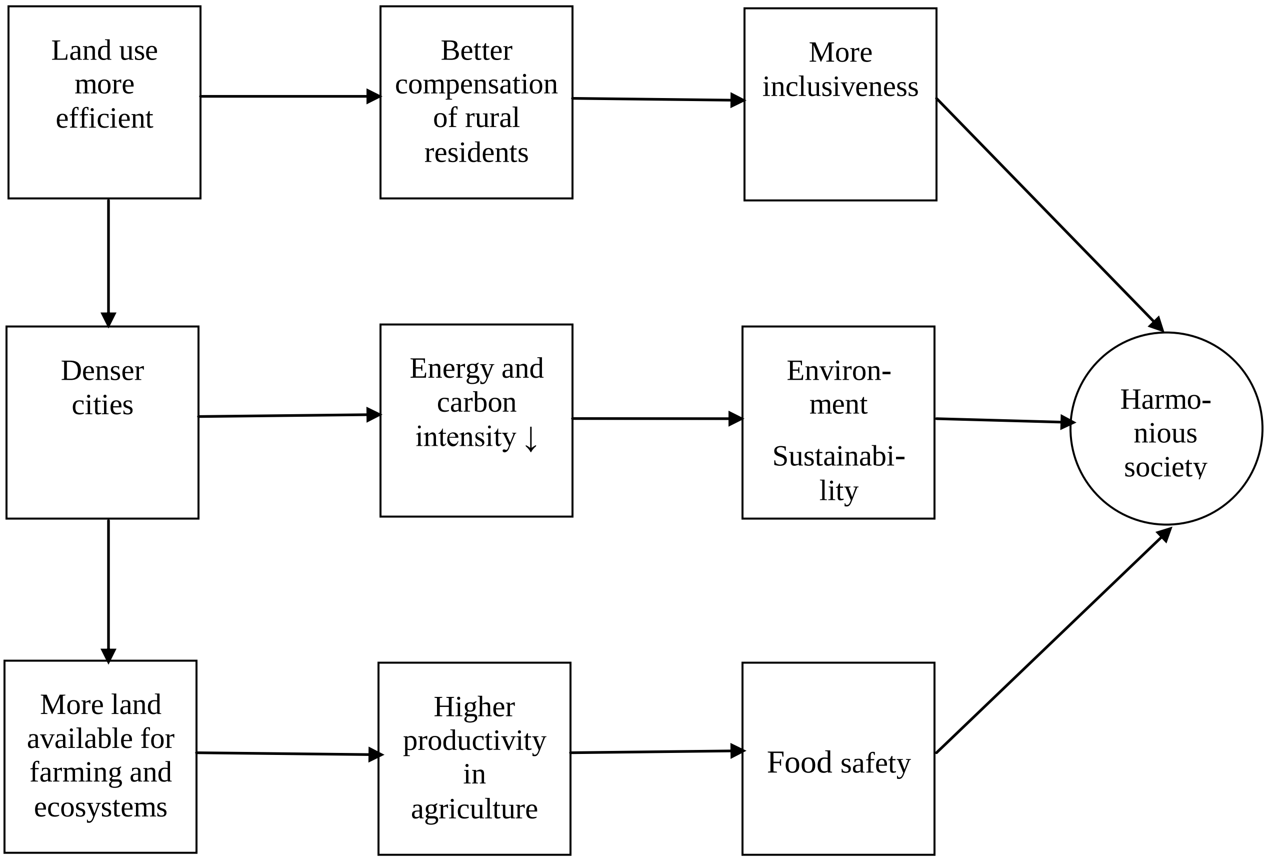
After the privatization of urban land in 1998, many Chinese cities have exhibited such worrying trends in the 2000's: destruction of ecosystems, waste of valuable farmland, congestion and deadly pollution with the explosion of car ownership. Reversing this trend will be critical to avoid jeopardizing sustainable growth and low-carbon objectives. The new urban model should be spatially compact like Hong Kong and Singapore. Megacities should be restructured in multipolar cities where economic activities and residency are not separated. They are high-density cities linked by mass transit systems

Fiscal tools specified above and deep bond markets can provide local authorities the means to finance the investments in building and transports to create and restructure cities. To give momentum to the new urban model the prerequisite is land reform combined with hukou, social services and taxes, as we explained above. Land reform is the process of unifying ownership in rural and urban land for construction under the rule of law.

The decisions of the third plenum provide the right framework. Rural land rights of farmers will be clarified, lengthened to 99 years and automatically renewed under the law, as they are for urban land. They will be registered (thorough inventory of land parcels) and guaranteed (certified written land lease). Arrangements for the transfer of rural land for the benefits of migrants will be made. Market mechanisms for sharing land value will be organized; land management will become an input of a modernized urban planning.

Incentives provided by the thorough land reform will redirect industrial activities to secondary cities where lad and labor are cheaper to make big cities more specialized in high-value services and innovation in attracting higher-skilled labor. Figure 5 exhibits the positive macroeconomic interrelations set up from land reform.

Figure 5. Benefits from land reform



2. Energy and low-carbon transition for a sustainable growth path

Moving to low-carbon economy in the 13th-5 year plan will be critical for the long-term economic prospect aiming at capital efficiency, technological innovation, knowledge and services. A low-carbon development roadmap has been elaborated by the NDRC[7].Since 2012 China has made progress in reducing energy consumption and CO^2 emissions per unit of GDP. Progress has occurred on four areas: controlling GHG emissions, adjusting industrial structure to services, improving energy mix and making energy use more efficient.

To support the transition to the new industrial base, innovation is key. It has led to the priority of moving closer to the technology frontier in 7 strategic industries: energy conservation and environmental protection, new-generation and information technology, biology, high-end equipment manufacturing, new renewable and nuclear energy, new materials and new energy-saving vehicles. Out of those 7 strategic sectors, 4 are directly committed to the energy and low-carbon transition.

7 NDRC, China's policies and actions for addressing climate change, report, 2013.

According to Green and Stern large gains in energy efficiency are correlated with improvements[8] in TFP: 1% rise in energy efficiency is concomitant with 1.1% growth in TFP. Increasing the share of services and high-tech industries belong to the investment climate strategy. Investment climate is linked to the expanded role of markets in allocating capital and resources. In turn, promoting market mechanisms is the goal of price reform defined on table 2 above.

Investment climate strategy must improve the ways firms interact with regulations and taxes, the access to quality infrastructures and to quality finance, the services of relevant inputs (labor, energy and water). The new urban model outlined above is the framework in which investment climate must develop.

- ***Investment climate: energy efficiency and innovations***

The main improvement in energy efficiency would come from the change in the energy mix in reducing drastically the use of coal that has persistently increased from 2002 to 2012 with the expansion of heavy industries and the surge in urbanization. As soon as the new leadership had been taking power, pollution was becoming a central political issue. In September 2013 the State Council issued an action plan on air pollution to reduce the concentration of small particles by 2017 after the State Council declared the “war on pollution” in March 2014[9]. It mandated higher efficiency targets for goal-based power generation. The goal is to achieve the peak in coal consumption in 2020 at the latest.

To provide the right incentives the fiscal reform presented in section III.1 will give the impetus. It should embody a tax on coal consumption to replace the ineffective existing resource tax. In October 2014 the State Council ordered that the coal tax be shifted to a value basis[10]. It would give local governments that get the tax the incentive to maximize the coal price that would restrain production. Over time the coal price will rise and restrain coal demand for the production of electricity, narrowing the cost gap with other forms of electricity production.

An early peak and a subsequent phasing-out of coal in energy consumption would deliver huge benefits: diminishing reliance on coal imports and improving energy security; mitigating water availability problems in the most water-stressed regions; diminishing air pollution in cities.

The shift in economic structure away from heavy industries will be the first contributor to coal-use abatement. Tougher pollution and energy-efficiency standards follow, as well as the pricing of carbon. To implement such sweeping reforms the main China’s advantage is political. China has a unified political force, a strong leadership and an elite that understands that the lead on climate issues will help developing new tech industries.

The priority for developing strategic industries has been asserted in strategic planning. Successful technology transition depends on three conditions: rapid demand growth, cooperation

---

[8] Fergus Green and Nicholas Stern, « An innovative and sustainable growth pat for China: a critical decade”, Centre for climate change economics and policy and Grantham research Institute on climate change and the environment, Policy Paper, May 2014.

[9] M.Meidan and A.Kroeber, Climate change and energy security, China Economic Quarterly Review, March 2015, pp.9-14.

[10] M.Meidan and R.Yao, King coal’s long, slow decline, China Economic Quarterly Review, op.cit., pp.28-34.

in R&D and strong competition among firms at the appropriate point of the innovation chain. In the past low-carbon innovation was handicapped by mispricing that ignored externalities.

A multi-dimensional framework is required to induce low-carbon innovations. The first pillar is the pricing of GHG emissions and other externalities associated with fossil fuels. The second pillar is a set of policies to target each link in the innovation chain from R&D through development and demonstration, i.e. early stage-supported deployment of R&D results where scale starts to become important.

For the time being new technologies with high potential of emission reductions are lagging worldwide. Investment in basic and applied research and technology development is much too low. At present China's comparative advantage lies in adopting and improving technologies developed overseas and cost-cutting through scale deployment and manufacturing process innovation. China now needs to move upstream the innovation chain in renewable energy, storage and vehicle technologies within their strategic industries: concentrated solar power, offshore wind, electric vehicles battery storage, smart electricity grids and battery charging.

To accelerate the momentum a carbon price is overriding as already emphasized. To move upward the innovation chain in the longer run China must establish well-funded energy research laboratories supported by long-term research strategy. These research institutions must be embedded within energy innovation clusters. Both the participation of private entrepreneurial tech firms and SOEs to get into breakthrough technologies are required. Then last but not least, a well-designed financial system is required.

- ***China's green Finance Task Force***[11]

Nothing can show how impressive is strategic planning in the pursuit of sustainable growth but the work of the Green Task Force in establishing a Green Finance System. The task force was coordinated by PBoC and gathered the three financial regulators of banks (CBRC), securities markets (CSRC) and insurance (CIRC), the central planning agency (NDRC), experts from policy banks, commercial banks, rating agencies, CASS and other universities, and non-governmental think tanks. The Task Force was co-sponsored by UNEP Inquiry for the design of sustainable financial system.

To fulfill the objectives of the third plenum in stimulating green investment and curbing investment in pollution-intensive industries, a comprehensive green finance system must be established to formulate efficient financial policies. To achieve economic restructuring and stimulate emergence of new growth areas, green finance institutional arrangements and specific financial products are needed. The objective of a dedicated financial system is to speed up the transition of industry, energy and transports into greener configuration, boost technology and and alleviate the fiscal pressure from environmental issues. For the time being promoting green credit has remained fragmented. During the 13th-5year plan China will build a more efficient financial system to provide the incentives to spur green investment. It will rest on price reform to increase the return on investment in green projects and to reduce the return on investment in polluting projects. Financing costs can be modulated on the price reform, providing higher expected

[11] PBoC, establishing China's Green Financial System, Summary Report of the Green Finance Task Force, March 2015

returns for investors in low-carbon projects and lower expected returns for polluting investment projects. A green finance system will impose mandatory disclosure requirements on institutions and enterprises, implement educational programs in green consumerism and build active green investor network.

The Green Finance System will be compounded of 4 domains: specialized investment institutions, fiscal and financial policy support, financial infrastructure and legal infrastructure. The first domain will made up of a China ecological development bank at the national level and green banks at the local level it will also create green funds through PPP arrangements. The second will diversify the financial instruments: discounted green loans, industry guidelines to provide incentives to banks and enterprises to issue green bonds and green IPOs. The third will develop carbon markets for emission trading, create green ratings to bring down financing costs and develop green data base for cost analysis. The fourth will make green insurance compulsory for key industries, establish lender liability to identify the environmental liabilities of banks and impose mandatory requirement for listed companies.

V. Conclusion: China and the world

In 1950 China was by far the poorest country of the world with GDP per capita less than 5% of the US. In 60 years the catching up has been outstanding. China's per capita income has reached 90% of world average and close to 25% of the US. In doing so China has followed the East Asian development path. However pursuing such a momentum in a country of this size and diversity is rather amazing. Having achieved about the same level of GDP in PPP value, China can pretend that the time has come for more assertiveness in world affairs.

The transformation of China's economy in the next 20 years will change the pattern of globalization. In its 2014 update, the OECD report "*Shifting Wealth*" pointed out that globalization is entering a new stage driven by the redeployment of EME growth onto their domestic markets. In Asia this new momentum will integrate the area with the support of massive infrastructure investment. Meanwhile the US-led, financial market-driven brand of capitalism will meet serious obstacles due to the intrinsic inability of markets to finance global public goods like climate, energy security, and ecosystem disruption. It means that global catching up in following Western-style past capitalism is a dead-end. 21st century capitalism will not create sustainable growth regimes without socio-political innovations from multiple regions of the world. The new urban life style will emerge from indigenous innovations whereby EMEs leapfrog Western models rather than imitate them.

China's assertiveness in world markets and world politics stems from this huge incipient regime change. The era of economic Western supremacy and political hegemony is happily closing, considering the devastation of colonialism in the 19th century and the horrors of the world wars in the 20th century. However the resistance of Western powers to any change in the post world-war II international institutions makes the transition perilous. China's politics has had to acknowledge the systematic blockage of the US Congress to any change in world governance. In the latest years the State Council has takn initiative to organize a web of trade and financial links in the emerging and developing world, based upon China's led international financial institutions: the BRIC's bank, the Silk Road bank and the Asian Infrastructure Investment Bank (AIIB).

However China does not want to overthrow the principle of open multilateral economy but work within these principles. China needs Western markets as much as Western nations need the huge Chinese consumer market. It is why the US attitude to exclude China in the transpacific trade negotiations and to block, albeit failingly, foreign partnership in the AIIB is sheer nonsense. China wants to take the lead in climate change policies and to secure energy and transport security. It wants to restore back its historical central role in Asia, all perfectly legitimate goals in soft power. To achieve this long-term goal, sustainable economic growth and political stability must go hand-in-hand.

China is more than a nation state. It is a millenary civilization that has created the institutions of a unitary imperial state. The empire has collapsed many times over two millennia of history. However, unlike other empires, it has always reunited. China has no desire and no need for global hegemony, because its founding culture does not pretend to carry out universal values. It wants to recover its central place in Asia. The islands of the South China Sea have been Chinese for 2.000 years. It is where the rivalry with the US takes root and might be dangerous. Indeed, what China wants in East Asia is no more than the Monroe doctrine the US applied to stave off foreign influence in their backyard. With the rest of the world, it wants to develop economic, financial, technological and cultural relationships and cooperate politically to secure the global public goods on which its own security depends.

References

Aglietta M. and Bai G. (2012), *China's development : capitalism and empire*, Routledge

Aglietta M. and Bai G (2014), China's roadmap for harmonious society, Policy Brief, n°3, Cepii, May 2014.

Bergère M.C. (2007), *capitalisme et capitalistes en Chine*, Perrin, Paris

Chow G. (2002), *China's Economic transformation*, Maiden MA, Blackwell Publishing

DRC and World Bank Report, "*China 2030. Building a modern, harmonious and creative society."* World Bank, 2013

DRC and World Bank Report, "*Urban China*", March 2014

Green F. and Stern N., « *An innovative and sustainable growth path for China: a critical decade*", Centre for climate change economics and policy and Grantham research Institute on climate change and the environment, Policy Paper, May 2014.

Huang Y. (2010), "China's great ascendancy and structural risks : consequences of asymmetric market liberalization", *Asian-Pacific economic literature*, vol.24, n°1, November

Kroeber A. (2014), "Xi Jiping's recipe for a leaner, stronger China", *China Economic Quarterly*, March

Meidan M. and Kroeber A., Climate change and energy security, *China Economic Quarterly Review*, March 2015, pp.9-14.

Meidan M. and Yao R., King coal's long, slow decline, *China Economic Quarterly Review*, op.cit., pp.28-34.

Miller T., "*China's urban billion",* Asian Arguments, Zed Books, 2012.

NDRC, China's policies and actions for addressing climate change, report, 2013.

PBoC, *Establishing China's Green Financial System*, Summary Report of the Green Finance Task Force, March 2015

Peerenboorn R., « so what exactly is socialist rule of law with Chinese characteristics?", *China Economic Quarterly*, December 2014, December 2014, pp.47-50