



CARNEGIE ENDOWMENT
FOR INTERNATIONAL PEACE

Congressional
Testimony

CHINA'S INTERNAL DILEMMAS

Testimony by **Dr. Yukon Huang**
Senior Associate, Asia Program
Carnegie Endowment for International Peace

U.S.–China Economic and Security Review Commission
Washington, D.C.
February 25, 2011

Links between political and economic liberalization

China's reform program over the past three decades has been predicated on the assumption that economic liberalization should precede political liberalization. The leadership has assumed that fulfillment of basic social and economic needs was more important than progress on other aspects of the "human rights" agenda given the consequences of decades of disappointing economic performance and the "excesses" of the Cultural Revolution.

Thus, when Deng Xiaoping took over the leadership role in the late 1970s, his strategy was to open up the country to the global economy by building an industrial based, export economy that capitalized on China's comparative advantages. By concentrating resources along the coast and providing special incentives and resources, China was able to establish economies of scale in production that transformed the country into the manufacturing assembly plant for the world. This provided the basis for a regionally integrated and more specialized production sharing network among East Asian countries which has, with few exceptions, led to rapid growth and surging current account surpluses throughout the region. (See Yukon Huang, *Reinterpreting China's Success through the New Economic Geography*, Carnegie Papers, November 2010)¹

The Chinese authorities have assumed that as long as the material well-being of the public was improving, social stability would be sustained and pressures for political liberalization moderated until the day when the governance structure of the country was ready and the populace better prepared to take on such responsibilities. For much of the post-Mao reform era with double digit growth, this assumption proved to be valid, but in recent years, as noted by various observers social unrest has intensified and tensions have been exacerbated by perceptions – rightly or wrongly – that equality in access to economic opportunities is no longer the rule and that personal liberties are being infringed upon. Even with rapid growth, widening disparities are now threatening the fabric of society and aspects of the development process are leading to more conflicts on an individual as well as a group basis. The recent visit of the Prime Minister to a "petitioning" office to signal that complaints from the general public should be handled more responsively indicates that the senior leadership is concerned that these tensions if unaddressed could threaten the foundations of the political system.

To what extent is there a link between a growth strategy that has transformed China into the second largest economy and rising social tensions which could threaten internal stability? Many economists have argued that rapid economic growth would eventually create the conditions for more "democratic" institutions along with more sustainable political processes. The empirical basis for this premise, however, is not firmly grounded.

China's unbalanced growth process and implications for income disparities

The growth path that China has been following is similar in certain aspects with the approach taken by other successful East Asian countries – notably its focus on a high investment, export led approach. But the strategy is unusual in the extent that it was

¹ http://www.carnegieendowment.org/files/reinterpreting_china_success1.pdf

spatially “unbalanced” and more state driven reflecting its centrally planned origins. This strategy was remarkably successful in putting the country onto a rapid growth trajectory but it also fostered an unusually sharp increase in income disparities. (See Yukon Huang, “China’s unbalanced growth has served it well” *Financial Times*, October 7, 2010)²

The link if any between growth and social stability is perhaps best exemplified by measures of income and social inequality which show that disparities have been increasing steadily. The Gini coefficient which provides an aggregate measure of inequality has risen steadily from about .30 in the early 1980s to around .48 today (with 0 being perfect equality – everyone’s income is the same - and 1 perfect inequality – one person has all the income). Although, a coefficient approaching .50 is high by global standards, it is comparable to that for the United States and other successful East Asian countries such as Singapore and Malaysia and lower than for many of the more prosperous countries in Latin America.

Although the overall degree of inequality in China is not unusual, how quickly it has risen from the Mao era when incomes were among the most equal in the world (but poverty was widespread) is a concern. Increasing tensions is better illustrated by the ratio of urban to rural per capita income which is above 3 and the ratio of incomes of coastal provinces to inland provinces which is close to 2.5 - both ratios rank among the highest in the world. Since two thirds of China’s population resides in interior provinces and more than half in rural areas, this regional differentiation is a major source of internal instability. The speed with which the economy has been transforming itself also means that China’s institutions have not had enough time to cope with rising expectations as well as needs.

Also worth noting is the contrast with less successful developing economies, where rising inequality is usually the result of stagnating incomes. Rural incomes in China have been increasing by about 4-5 percent annually – which is unusually high by international standards – but urban incomes have been increasing twice as fast and thus regional disparities have soared over the past several decades.

Studies vary in attributing inequalities to either cross-regional differences or intra-provincial factors, but urban-rural disparities tend to be much greater in poorer provinces than in the richer coastal provinces. Thus much of the inequality in China is explained by the uneven pace of urbanization across provinces, especially in the poorer inland regions. Regional factors are also important, because of the larger urban-rural differences in the more remote interior. In these areas, harsh natural conditions militate against higher agricultural productivity and more isolated settlements raise the cost of providing social services.

The Government has launched a series of regional development programs to address these disparities – notably the “Go West” program initiated in 1999 to address the exceptionally severe ecological needs of western provinces which rank among the poorest in China; revive the northeastern provinces strategy in 2003; and the more recent “Center Rising” initiative which has focused on the more densely inhabited areas in the central parts of China. While these efforts have led to visible improvements in the availability of social infrastructure in less advantaged areas and moderated some of the past “imbalances”, they have not yet been able to reverse the trends in rising inequality. Although China’s social indicators in absolute

² <http://www.carnegieendowment.org/publications/index.cfm?fa=view&id=41699>

terms have continued to improve, regional disparities remain substantial. The proportion of people in rural areas, for example, with no education is three times that in urban areas. Child and maternal mortality is twice as high in rural areas as in cities. Thus some of the increase in social tensions is the result of differential access to social services.

Looking to the future – policy priorities

Recent growth patterns suggest that a process of gradual convergence is underway between the coastal provinces and the interior; GDP growth rates for the interior provinces have recently exceeded those along the coast. But the advantages of location will likely persist even if narrowed with agglomeration effects continuing to favor the larger and more globalized urban coastal areas. What then should be the course of future policies given public pressures to deal with increasing disparities and rising social tensions?

Both economic theory and experience indicate that government initiatives should not try to “balance the location of productive capacity” across regions if China wishes to maintain its rapid growth. Global experiences in many other countries in Latin America and Europe have shown that investment policies based on trying to establish new production centers in regionally isolated areas usually fail given market realities.

To evolve a socially and politically more sustainable growth process requires a strategy to “moderate differences in economic welfare” between the coastal and inner provinces and between rural and urban areas. This would involve a three-prong approach that builds upon China’s past successes by: (1) strengthening the distributional aspects of the fiscal system so that regional and rural-urban differences in access to social services are reduced; (2) encouraging complementary regional development policies that recognize and build on the uniqueness of geographic and inherited differences rather than trying to work against them; and (3) eliminating jurisdictional and institutional barriers that inhibit mobility of labor while strengthening infrastructure links so that the regions and rural-urban areas are better connected.

Fiscal policies to promote more equitable outcomes

With the major tax reform of 1994, the discretion based revenue-sharing system was replaced with a more rule based fiscal assignment system allowing the central authorities to use fiscal policy more actively for redistribution. Although revenues have since grown rapidly from 10 percent of GDP in the mid-90s to nearly 25 percent today, the impact of the fiscal system in providing a more equitable access to social services is still modest - in part because of the way expenditures assignments are cascaded down to local levels without providing commensurate funding. Sub-national expenditures at over two-thirds of total spending is very high by international standards and in a country with such wide regional disparities, getting the right mix of revenue and expenditure assignments at each level of government is especially difficult. These consequences are more significant in the poorer inland provinces and partially explain why urban-rural disparities are greater there relative to the coastal areas.

Part of the problem in channeling more funds for social programs is political due to the reluctance of richer provinces to redistribute in favor of poorer regions. Redistribution

within an existing pool of resources is always more contentious than providing more funding when the pie is getting larger. A rapidly growing economy will provide more funding on its own for such efforts but there are policy actions that would enlarge significantly financing to address the regional differences in social expenditures.

One of these is to oblige state corporations to pay higher dividends to the Government which could then be used for such programs. China is unusual in that corporations have not been paying any significant share of their retained earnings to either households or to the Government. Given their surging profits in recent years, this has encouraged companies to invest more than would make sense on efficiency grounds and distorted the pattern of investment and consumption. Although there was a recent move to increase the dividend payout ratios, the amounts are still only a fraction of those in comparable countries. A major adjustment in this regard with the additional revenues channeled into social expenditures would go far to reduce differences in welfare across regions. This would help address U.S. concerns about global trade imbalances since the shift would increase consumption, moderate growth in investment for industrial production and help offset the bias in favor of exports.

A word of caution, however, that even with increased allocations for social programs, the impact in terms of mitigating social differences and providing a greater sense of security will take time. A common assumption, for example, is that increasing social programs will encourage the population to consume more and save less as income security is enhanced. Studies have shown that while increased public support for education and health services does increase household expenditures for these services, the recent efforts to improve coverage of the pension system has actually led to increased savings since households remain unconvinced about the longer-term viability of such programs and thus have increased their savings to offset the higher contributions that they are now obliged to make.

Role for region specific programs

Like many other countries, China has relied on locality specific policies to address regional disparities in an attempt to deal with social tensions. Their effectiveness – as in other countries – depends on whether such policies are consistent with differences in regional resource endowments and comparative advantages. In China, this means recognizing that the priority for the Western Region is defined by its fragile ecological conditions and the need to strengthen its human capital base; for the Northeast, to encourage more aggressive enterprise restructuring with supportive social protection systems and tapping its natural agriculture-based advantages; and for the Central Region, to strengthen inter-modal transport links and logistics infrastructure as commercial activities shift inward to serve major population centers as growth becomes more domestically driven. Broadly China's regional programs have been respecting these differences. But there are concerns that more recent programs have led to some wasteful expenditures as part of the stimulus program for dealing with the global financial crisis.

Importance of labor mobility and the “hukou” system

Cutting across all these themes, is the role that more flexible internal labor migration policies can play. Access to housing and social services for migrant families without urban residency

status remains unequal, although guidelines have become more flexible in some jurisdictions. However, for many migrants security is still linked to their “*hukou*”³ in their home province which provides use rights to rural land and social services. In the absence of more formal land use markets, the equally contentious issue of granting residency to migrant labor in the cities is difficult to resolve. The most effective instrument to deal with rural-urban disparities would be to liberalize further the “*hukou*” system. Elements of the system have served China well in avoiding the urban slums characteristic of many other major Asian cities. Thus the issue is more about managing rather than halting the process of rural-urban migration to moderate social tensions given the pressures for a more urbanized China.

Policy-makers continue to be reluctant to liberalize the “*hukou*” system because of fears that China’s cities will become even larger and potentially unmanageable. A quarter century after the reforms began, China’s urbanization rate has more than doubled and is now rapidly approaching 50 percent. At the current stage of development in metropolitan areas, positive agglomeration effects dominate negative congestion effects although China’s cities face major environmental challenges and urban transport systems need to be improved.

Contrary to popular perceptions, in relation to its population and land mass, China’s major cities are in fact too small rather than too large. Building new “secondary” towns on the edge of existing cities may be effective only if there is strong demographic, economic and environmental rationale. Fragmentation in large cities (agricultural/vacant land within the contiguously built up city) resulting from China’s typical multi-ring spatial format of city development has created less densely utilized enclaves, unnecessarily increasing urban transport costs and provision of social services. More efficient urban planning which would infill “leapfrogged” areas will be an important issue as urban population growth continues to accelerate.

Finally for migrants to leave rural areas or inner provinces, they need to be able to “capitalize” the value of their land holdings and move with enough assets to bring their families and start afresh in typically more urbanized and prosperous localities. Development of secondary markets that would allow farmers for example to sell their land use rights is critical in this regard along with more developed formal markets for transferring rural property. In principle these actions are possible but practices are not uniform and markets are either distorted or tightly controlled by local authorities to the disadvantage of potential migrants. Issues relating to property transfer and confiscation for development are major sources of tension in both rural and urban areas and such incidents often trigger localized protests.

Some further thoughts – inflation and corruption

Over the past year, inflation has ratcheted upwards and drawn increasing attention from the political leadership. Many observers see the surge in prices as a potential source of internal

³ “Hukou” – a legacy of the past centrally planned economy - is a household registration system that establishes a person’s official place of residency and gives them right of access to social services and other rights including housing and land use. Changing one’s official residency is tightly controlled by local authorities. Thus without a hukou, most migrant households do not have access to the education services or employment rights that are available to local residents. This makes it difficult for them to bring their families or to make permanent a work related move.

instability if it gets out of control. Others do not see this as a longer-term issue since most of the increase is being driven by rising food prices – due in part to weather related events. China has the resources and stockpiles to deal with the foreseeable consequences. The economic implications of inflation are more mixed than generally recognized. Price increases are helping to drive up the real value of the yuan and thus a factor in moderating China's trade surpluses. In addition, for the first time in several decades, rural household incomes increased faster than urban – thanks to the surge in agriculture prices. But with a rising urban middle class, the political implications are another matter.

More generally with a rapidly changing economic scene and a more mobile and better educated labor force with higher aspirations, social dissatisfaction increasingly emanates from the lack of credible institutions and processes for the populace to express their concerns. Venting one's frustrations in ways that are perceived to be taken seriously by the authorities are as important as actually resolving an issue.

Much of this frustration is directed at failings that emanate from corruption and inconsistent application of the rule of law. Corruption in China is a major concern and source of potential internal instability. Even the senior leadership has recognized its seriousness in noting that if unchecked it could threaten the credibility of the Party. However, its pervasiveness and corroding effects are not unusual in the Asian context.

Whether public perceptions about corruption will ever lead to the kind of agitation that has overthrown regimes elsewhere is less obvious. One distinguishing feature of corruption in China is the view that while corruption is endemic at the local level, the senior leadership is seen as reasonably "untainted". This is the result of a political system that mandates the senior leadership to live in a "fishbowl" environment and be subjected to scrutiny in exchange for assuming power. The cross-checks that come with a turnover in the top leadership every five or ten years also mean that blame becomes less personalized. Thus protesters misconceived or not, often see the central authorities as a potential savior in addressing abuses at the local level. Currently, civil unrest tends to be driven less by visions of a regime change but more by drawing attention to abuses that affect daily lives. Nevertheless, examples of dissatisfaction are becoming more widespread and there are segments of society that are thinking more seriously about social and political evolution in ways that generate pressures for more fundamental changes.

How China handles this complex set of issues will have profound implications for dealing with disparities and related tensions with consequences for internal security. These outcomes also have implications for U.S.-China relations.