

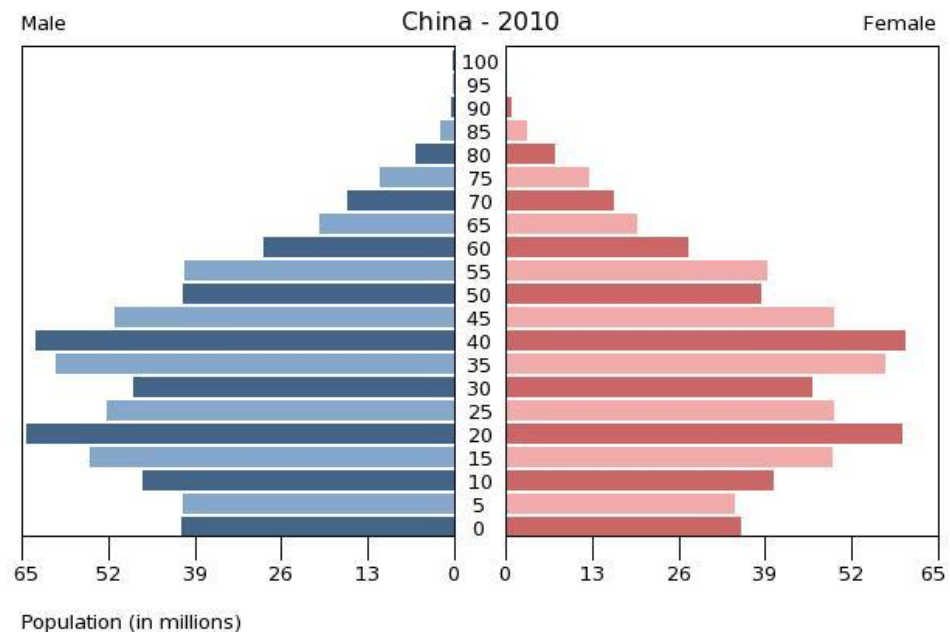
How Will Changing Development Patterns Affect China's Political Prospects?

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[I am] fearful, but don't know why and of what, this is the feeling in my heart and that of many others. The powerful are fearful, so are the powerless; those who have jobs are fearful, so are the jobless; the poor are fearful, so are the rich; the elderly are fearful, so are the children. The whole society and everyone are enveloped in fear, but nobody knows why, this is the true state of the psychology and plight of today's Chinese.

Yan Lianke, Chinese writer¹

For more than thirty years, China has weathered a variety of internal and external crises and grave challenges to maintain stability and achieve remarkable economic growth. As is known to all, China has become the world's second largest economy and the largest exporter with the world's largest foreign exchange reserves. While in terms of per capita GDP China ranks much lower because of its large population, the scale of China's transformation in a generation's time is astounding.



¹ 阎连科, <http://weibo.com/2056049087>, August 18, 2011, accessed August 20, 2011.

The basic patterns of China's economic development are well known and include the following:

- **Labor:** a large and reasonably well-educated population has been the source of a disciplined labor force. Until around 2005, labor costs were low and the supply of labor for basic jobs was virtually unlimited. Labor costs have risen in recent years but at the same time investment in education and R&D has also grown rapidly.
- **Land:** as a legacy of the Chinese Communist Revolution, the Chinese state (local governments) is the owner of all land for commercial and industrial development in urban areas. Rural communities own their land but are not free to convert them into land for commercial and industrial usage. This has given the Chinese state unparalleled power to speed up development—whether erecting high-rises or building super highways and high-speed railways, and to make land available, often at below-market prices, to industrial investors. Compensation was paid to relocate residents, but until recently the regulations for such compensation were designed to keep the cost of land requisitions low. Unlike in the U.S., there is no Takings Clause in China's constitution. Generally local authorities make significant profits by auctioning off the land thus acquired for commercial development. These profits have become the most important source of extra-budget revenue and are used for local infrastructure investment and other forms of discretionary spending by local authorities.
- **Leadership and Policy Commitments:** Steadfast in maintaining its political monopoly, the leadership of the Chinese Communist Party (CCP) has been deeply committed to economic growth. In the words of Deng Xiaoping, “development is the hard truth.” China's leaders have articulated the goal of building a “moderately well-off society” by 2020. In addition to direct government investments (esp. highways, railways, airports, dams as well as government office buildings), the state sector (such as telecoms, oil and gas, petrochemicals, and power) has also been major investors. Moreover, the Chinese government has generally introduced policies and institutional reforms to improve the protection of private property rights, however imperfect they are, and thereby improve the incentives for investors, both domestic and foreign. Even though the state remains dominant in certain heavily regulated sectors, the relative size of the non-sector sector has continued to expand.
- **Macroeconomic Stability:** The growth in investment has been supported by a high rate of savings made possible by stable banking, financial, fiscal and foreign exchange policies as well as a demographic structure with a low dependency ratio. Fiscal reforms adopted in 1994, buoyed by rapid growth, have put the Chinese central government on a sound fiscal footing. The banking system, dominated by state-owned giants, operates like utilities; the People's Bank of China (PBOC), the central bank, not only sets bank reserve ratios but also both deposit and lending rates. Moribund at the turn of the millennium, the major banks were recapitalized in the 2000s and were among the world's most profitable as of 2011.

The bulk of the funds taken from savers, often at negative real interest rates, are funneled into the state sector. Since the early 1990s the PBOC has also set the exchange rate of the Chinese currency at competitive levels to support its export sector.²

It is now widely recognized that China's hyper-growth has come at significant costs. In most countries, the shares of capital and labor in GDP tend to be relatively stable.³ China, however, has posed a puzzle. While the Chinese political system has remained under Communist Party rule, Chinese government sources report that labor's share of GDP in China declined sharply from 51.4 percent in 2000 to 39.7 percent in 2007.⁴ Arvind Subramanian of the Peterson Institute for International Economics comments that this significant redistribution of income away from workers "might well be the mother of all redistributions." He also notes that, as a result of this large shift, the People's Republic of China "has perhaps the lowest labor share of any major country in the world."⁵

The declining labor share of GDP means that that rapid GDP growth has not brought a corresponding increase in individual consumption and living standards. On the eve of the global recession in 2007, Chinese household consumption, which had held relatively steady until about 2000, fell to 35.4 percent. Capital formation, including changes in inventories, rose to 40 percent of GDP, or about 15 to 20 percentage points above values of the capital share in countries at similar levels of developments.⁶ Net export of goods and services accounted for almost 9 percent of GDP. The massive investments in China were expected to drive down returns to capital over time. Yet remarkably this did not happen prior to the onset of the global economic crisis in 2008. According to Bai et al, while the rate of return to capital did decrease between 1979 and 1992 to about 20 percent, it stabilized at the 20 percent level between 1998 and the early 2000s, high relative to those for most advanced economies.⁷ The fusion of political power and economic interests in China has been a haven for capital as well as for China's power elite.⁸

² An excellent overview is Carl Walter and Fraser Howie, *Red Capitalism: The Fragile Financial Foundation of China's Extraordinary Rise*. New York: Wiley, 2011/2012.

³ Douglas Gollin, "Getting Income Shares Right," *The Journal of Political Economy*, Vol. 110, No. 2 (Apr., 2002), pp. 458-474.

⁴ "发改委起草大范围提高社会工资等消费刺激方案," *经济观察报*, November 22, 2007, at <http://finance.sina.com.cn/roll/20081122/03155540190.shtml>. It should be noted that such numbers are at best approximate and figures calculated from flow of funds data show substantially different results. I am indebted to Calla Weimer for discussing the data complexities with me.

⁵ Arvind Subramanian, "What Is China Doing to Its Workers?" *Business Standard*, February 8, 2008, accessed at <http://www.iie.com/publications/opeds/oped.cfm?ResearchID=885> [2008-10-25]

⁶ Gollin 2002.

⁷ Chong-En Bai, Chang-Tai Hsieh, and Yingyi Qian, "The Return to Capital in China," *Brookings Papers on Economic Activity*, 2006, 2, pp. 61-101.

⁸ Bloomberg.com has produced a series of investigative reports on how China's princelings and their families, including the relatives of incoming President Xi Jinping, have acquired large business interests.

Another angle to take on China's economic imbalances is that of inequality. Whereas China in the early 1980s was one of the world's most egalitarian economies, it is one of the most unequal today. According to the World Bank, China's Gini coefficient, based on expenditure shares by percentiles of population, had risen to .447 by 2001, ranking China the second most unequal, after Malaysia, among the East and Southeast Asian countries included in the World Bank database.⁹ Chinese research suggests China's Gini coefficient had risen further to at least .46 but the National Bureau of Statistics has stopped releasing its calculations of this coefficient in recent years. In interviews, some Chinese researchers suggest China's Gini coefficient may have risen to as high as .49, putting China in the same league as Mexico and the United States.

Rising inequality coupled with perceptions of corruption have fuelled a sense of inequity and contributed to a rise in the number of "mass incidents", including mass protests and riots, from around 10,000 in 1993 to an estimated more than 180,000 as of 2011. [Again officials have stopped releasing exact numbers.] In general the petitions and protests are efforts to seek redress, often for injuries caused by government actions to take over land and other rights on what are considered unfair terms. As the Chinese economy has boomed and asset values have risen, the struggle for property rights has intensified. There are also protests prompted by environmental concerns and the dramatic confrontation in Shifang, Sichuan in recent days is but the most salient example. Such struggles are in many ways welcome from the perspective of governance and social justice.¹⁰ What are especially disturbing to authorities are riots against local authorities that are touched off by minor scuffles and traffic incidents in Wanzhou (Chongqing), Chizhou (Anhui) and other interior localities as well as boomtowns such as Dongguan, Zhongshan and Shenzhen in Guangdong. Such events reflect the sense of popular discontent—fuelled by cleavages imposed on migrants who are at best second-class citizens in the cities in which they reside--and rising class tensions in parts of the country and raise the specter of social instability.¹¹

So far the Chinese leadership has been able to rely on rapid growth and improvement of people's living standards to boost its legitimacy. There is growing evidence in recent years that the returns on such policies have begun to level off, if not yet declined. Surveys by Gallup and others indicate that in spite of growing prosperity, people's sense of happiness in China has ceased to improve. While the Chinese public continue to show strong support for the country's direction of development, a tracking opinion survey conducted by Horizon Research Consultancy Group, one of China's leading independent survey organizations, shows that the percentage of respondents who

⁹ World Bank 2005a: Table 2.7; for trends and various forms of measurements, see World Bank 2005b.

¹⁰ Xi Chen, *Social Protest and Contentious Authoritarianism in China*. Cambridge: Cambridge University Press, 2011.

¹¹ Dali Yang, "[Economic Transformation and Its Political Discontents in China: Authoritarianism, Unequal Growth, and the Dilemmas of Political Development](#)," *Annual Review of Political Science*, no. 9 (2006), pp. 143-164.

said they were happy has steadily declined from just under 80 percent in 2004 to under 50 percent in 2010.

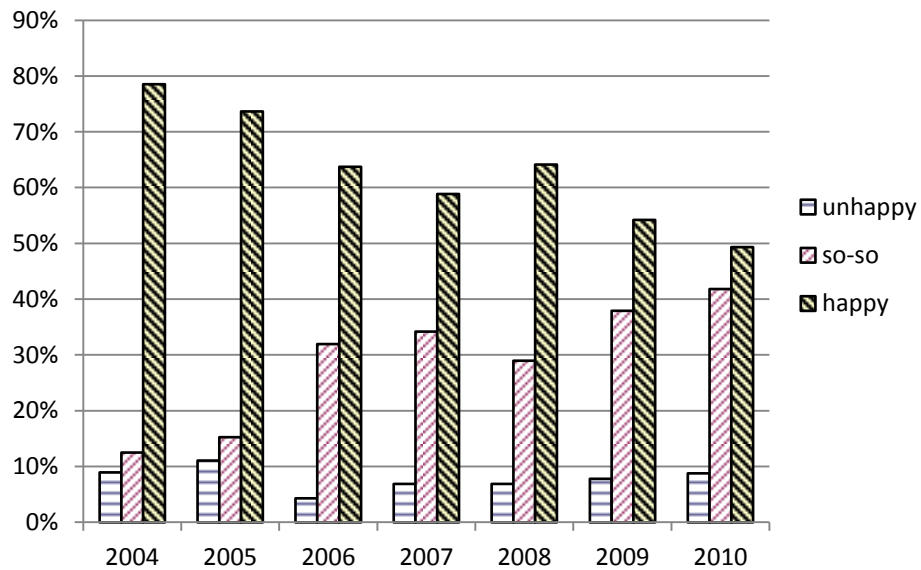


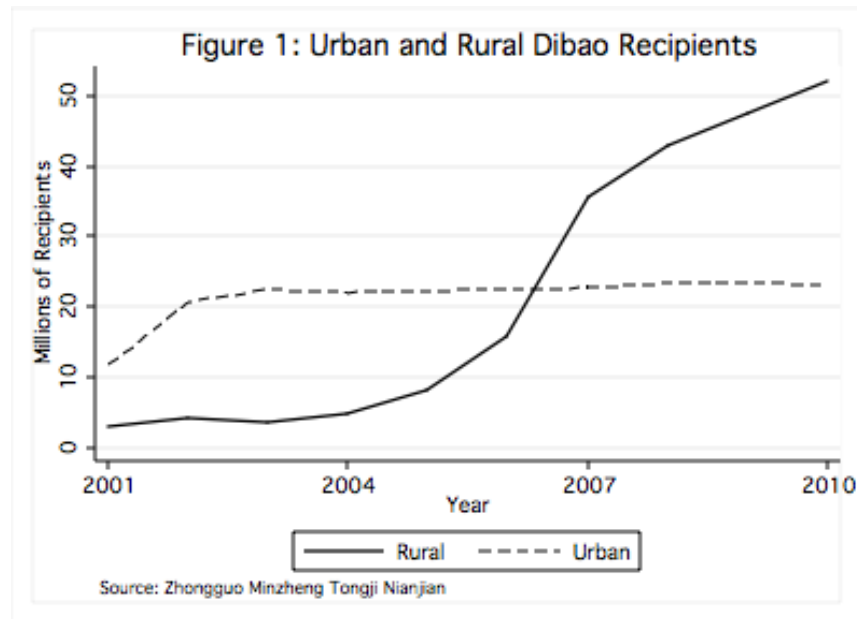
Figure. Percent of Respondents Feeling Happy or Unhappy, 2004-2010

Source: Lijun Chen and Dali Yang, “Old Age Care Concerns and State-Society Relations in China: Public Anxiety and State Paternalism,” *Journal of Asian Public Policy*, vol. 5, no. 2 (July 2012): 136-154.

So far the Chinese leadership has adopted both sticks and carrots to promote social peace. By placing “stability above everything else”, a stability maintenance system has been put in place, including increased investment in police equipment to efforts to censor and guide opinions on micro-blogging services. While for now the system has served its purpose, the costs of this system have also been extraordinarily high. Some cities such as Chongqing are known to have used draconian extra-legal means to crack down on crime and political opposition. Indeed, sometimes to drive to ensure stability and “harmony” has generated perverse incentives. Playing to local authorities’ fear of being marked down by their superiors, petitioners sometimes plan their moves in order to extract more concessions from local authorities.

Meanwhile, making use of its growing fiscal strengths, the Chinese government has adopted a broad range of policies to improve education, health insurance, and retirement, with special attention to rural areas. In a few years’ time, the Chinese government has been able to put in place a rural new co-operative health insurance scheme to cover most of the rural population. There is also a drive to provide some retirement coverage for all segments of the population by the end of 2012. Under this scheme, which includes an individual contributory account that allows for varying amounts of contributions, the Chinese government has started with a government

supplement set at no less than 30 yuan per month. Those aged 60 or above can get a monthly retirement payment, with the basic amount covered by government no less than 55 yuan per month (same as rural). Though these amounts are small, they put the government on the hook for social protection for a population that has complied with the government's draconian family planning policy. I believe we are witnessing the making of a new social contract in China.



Source: Travis Warner and Dali Yang, “Marketization, Democratization, and the ‘Reach of the State’ in Rural China,” Paper presented at the Conference on Power in the Making in China, Oxford University, 2012.

Prospects:

For the present, China has had an enviable record with sustaining growth in spite of growing social cleavages and tensions. Even while we detect significant discontentment, it is useful to keep in mind the broad range of social, economic and political measures the Chinese leadership has already adopted to cope with these tensions. Should additional problems emerge, it is likely that the Chinese leadership will adopt additional measures as well as some policy innovations.

Yet developments in many countries have shown that major political earthquakes can occur in countries seemingly in stasis and thus one needs to be open to new possibilities. With growth slowing down and sociopolitical strains growing, it is useful to ask questions about the sustainability of China's development. With rising labor and land costs, growing public demands for environmental protection, and slowing demand in export markets, China's development appears to have reached a turning point. In the twentieth century, only a small number of middle income economies, including several

around China (Japan, South Korea, Singapore, and Taiwan), were able to make the transition to high income status. Can China, whose population is already ageing rapidly, follow in their footsteps; or could China succumb to what's known as the "middle income trap"? To what extent might reforms be adopted to bring China onto a path of a more innovation-driven economy?

It is against such questions we have to ask about China's transition to a new generation of leaders, the caliber and vision (if any) of such leaders, and the dynamics of relations between economic development and state-society relations in China. I await eagerly the discussions at the conference. For now, I want to raise another question. It is conventional wisdom that South Korea and Taiwan significantly boosted outlays for social welfare only after they have made the transition to democratic rule. Yet evidence suggests that the boost for welfare began before the democratic transition because the authoritarian leaders boosted welfare in order to relieve popular pressures. Does China's embrace of populist welfare and social insurance policies in recent years signal the same sort of dynamics?