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Testimony before the U.S.-China Economic and Security Review Commission China ahead of the 13th Five-Year Plan: Competitiveness and Market

I am honored to have this opportunity to join distinguished colleagues and share my thoughts on China's political economy to the U.S.-China Economic and Security Review Commission. Before I get to the key points of my remarks today, I'd like to note that the development and dynamics of China's political economy have been the major preoccupation of my academic research career. I started by examining the mechanisms and forces that shaped China's rural reforms from the 1950s to the 1980s as well as the competitive dynamics for regional diversification and development. In the last decade I've been especially interested in issues of China's institutional reforms, regulation, governance, and state-society relations. It is obvious today that the future direction of Chinese development is among a small number of the most fundamental questions concerning the future of humankind and I commend the Commission's role in helping to better understand China's developments in its variegated dimensions.

I am speaking on Panel III, "The Broader Implications of China's Five-Year Plans" and am especially pleased to do so and to link the discussion of such plans with the extraordinarily fluid context within which preparation for the 13th five-year plan occurs.

Institutional History and the Transformation of China's Planning Apparatuses

Historically central planning in China never gained the status, complexity and sophistication that were reached in the USSR. Indeed one could argue the PRC genuinely practiced central planning only during three years of the first five year plan period (1953-57). This was then followed by massive national campaigns such as the Great Leap Forward and the Cultural Revolution, which did much to undermine the central planning apparatus.

Following Mao's death, the efforts to promote 'reform and opening' occurred against the background of the Mao-era political turmoil. Indeed the turmoil and destruction of the Mao era furnished much impetus for the post-Mao reforms. In particular, as I discussed in *Calamity and Reform in China*, the major rural reforms in China's provinces in the late 1970s and early 1980s were significantly driven by the severity of famine caused by the Great Leap Forward (1958-1960). Meanwhile, national leaders in China, many of whom had suffered from Mao's brutal political campaigns, recoiled from Mao's emphasis on class struggle and have kept their eyes steadfastly on economic development through reform and opening up.

The path of reform and opening up has helped the Chinese economy to become increasingly diversified in ownership and resulted in substantial restructuring of the state-owned sector. Economic reform and transformation have in turn helped prepare the ground and indeed demanded changes in the structure and functions of government. Economic reform and government restructuring thus stimulated and interacted with each other, leading to profound changes in the nature of China's economic governance. In *Remaking the Chinese Leviathan*, I offered a comprehensive survey and examination of these changes, including the rationalization of the administrative state, the strengthening of the fiscal sinews for the central state, the development and enhancement of regulatory apparatuses, the introduction of myriad institutional mechanisms to cut down on waste and improve financial supervision, and the evolution of state-business relations. Of particular interest to the task at hand was the restructuring of the Chinese government structure related to economic planning and steering. In the words of then Personnel Minister Song Defu, the contradictions between the government setup and the market economy had become sharper day by day. Lack of further government reforms would "obstruct the development of society's productivity, affect the relations between the Party and the masses, and create a heavy burden on the state and the people."[i]

Between 1998 and 2002, the government rationalization program unleashed by then Premier Zhu Rongji trimmed authorized staff size in all Party, government, and government-sponsored mass organizations by 1.15 million (including 890,000 at the municipal, county and township levels). The heaviest axe of the government restructuring fell on the industrial ministries that had been the bulwarks of the central planning system. Between 1998 and 2001, The Ministries of Chemical Industry, Coal Industry, Electric Power Machine-Building, Metallurgical Industry, Internal Trade, Forestry as well as the national councils of Light Industry and Textile Industry were streamlined and downgraded and eventually merged into the State Economic and Trade Commission (SETC). In 2003, the SETC was further merged with the planning commission to become the National Development and Reform Commission.

As a result of the institutional reforms, the "planning" superstructure for China includes National Development and Reform Commission (NDRC and the affiliated Energy Administration), the Ministry of Industry and Information Technology (MIIT), the Ministry of Commerce, and the State Assets Supervision and Administration Commission (SASAC).

The state-dominated financial system has also undergone significant reforms. The Ministry of Finance remains one of the most powerful central government ministries. The People's Bank of China is not an independent central bank but has nonetheless gained much capacity and prowess. Meanwhile, partly in response to major financial problems that afflicted China's financial sector in the 1990s and early 2000s, the Chinese leadership established specialized regulators for securities, insurance, and banking. With the China Banking Regulatory Commission, China has distinguished itself as one of the major countries to establish a dedicated banking regulator.

The structure as described here makes China's planning apparatus look strikingly similar to those in China's East Asian neighboring economies in their heyday. The institutional transitions described above indicate the profound changes China's economy has undergone. Whereas the Chinese Party-state continues to own SOEs and major banking and other financial institutions, the Chinese economy is no longer the administered economy of the 1970s. As previous panelists have noted, China has a large and robust private sector and the Chinese economy is diversified both at home and internationally.

The Chinese government continues to issue growth targets for the Chinese GDP annually and in its five-year plans, but such numbers, particularly those for five-year periods, are largely forecasting exercises. For much of the time since 2000, the Chinese economy overshoot government target growth numbers by large margins, suggesting that government targets were honored in the breech. It's only since 2012 that Chinese GDP growth numbers have come to be very close to the targets of between 7-8 percent per year.

Dynamics and Challenges of Economic Restructuring

Whereas much emphasis in economic analyses on China is on the need to rebalance in favor of more consumption and away from an investment-led growth model, it's also important to take a look at the socio-political foundations of sustainable development.

Until recently, the Chinese economy rallied under the rubric of Deng Xiaoping's "One Center, Two Basic Points." That one Center referred to "economic construction" and it acquired the status of a national fetish. Politicians' incentives matter in economic development. In the past thirty years, local officials in China have played an indispensable role in the rapid rise of TVEs, the gradual decline of SOEs, and the dramatic improvement in infrastructure, the rise of massive new cities, and the emergence of China as the world's workshop.[1]

What separates Chinese officials from hand-grabbing governments in most developing and transitional countries? Supporters of the fiscal federalism thesis argue that fiscal contracting and factor mobility forced the central and local governments to respect property rights and promote business development. Some other researchers believe that Chinese local officials are mainly motivated by the career prospect of promotion to develop their economies. Building on some of the insights from these existing approaches, my coauthors and I offer an alternative analytical framework that can account for the Chinese local governments' continual drive for growth as well as the key growth policies adopted. The introduction of three institutional factors, i.e. central-local fiscal arrangement, regional competition, and industrial linkage, allows us to explain the evolution of revenue-seeking local government officials over time: their drive to launch SOEs and TVEs in the 1980s, their efforts at protectionist developmentalism as competition began to heat up, and, since the 1990s, their divestiture of local SOEs and focus on land taking, urbanization, and industrial buildup.

Whereas the existing approaches tend to depict the Chinese transition and development experience in a rosy light, e.g. "China miracle", "successful transition", "amazing growth", our alternative framework allows us to both explain the dynamic aspects of China's growth and

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[1] This section is adapted from Fubing Su, Ran Tao, and Dali L. Yang, "Rethinking the Institutional Foundations of China's Hyper Growth," forthcoming.

transition as well as recognize the costs and limitations of China's developmentalism. In fundamental ways, China's remarkable growth since the 1980s has relied on a certain disregard for, if not outright violation of, the rights of labor, land, intellectual property, and environment plus growing access to developed country markets. Indeed, on numerous occasions the taking of land was a violent process, with local authorities being a key player in land-grabbing. Even today, in spite of revisions to the regulations on land requisitions, demolitions or land takings can still turn bloody when local officials rush to obtain the land and ride roughshod over residents who refuse to give up.

Yet it is also clear the essential ingredients of China's developmental dynamism can also be its limitations. The most striking corollary of local developmentalism in China is a sustained rise in land prices for commercial development and in property prices, which, together with loose credit, fuelled much speculation and a major property bubble by the early 2010s. Concerned about the bubble getting even more out of control, the Chinese central government adopted various measures to cool the sector but there are concerns that a bursting of the property bubble are putting substantial pressure on China's fragile financial system. So far the effect of property crashes has been confined to a small number of cities such as Erdos (Inner Mongolia) and Wenzhou that are relatively far from metropolitan areas. Domestic construction from railroads to power plants is also moving toward a slower mode of expansion than in the past.

While exports have grown in tandem with the massive buildup of manufacturing capacity in China, it is simply unacceptable for China to keep having massive surpluses in trade and it is also a growing burden to manage its multi-trillion dollar foreign exchange reserves. In any case, the great recession of 2008-09 has curbed demand from developed economies and thus Chinese export growth. Meanwhile, with rising land and labor costs in China, China has begun to see some low-end manufacturers move away from China.

The Chinese central government has been at pains to encourage domestic consumption and to promote investment in education, health care, and innovation, with some success. Yet the transformation of China's development patterns into one based on innovation and domestic consumption also calls for transforming the dynamics of Chinese local developmentalism. This will not be easy as a constellation of interests has coalesced round this developmentalism and profited from it. Local governments across the country are addicted to the land-based industrialization and urbanization. Through land requisitions and leasing, local governments have built up ties to businesses and developers and secured loans from banks and other financial interests. Through these webs of interests and the investment projects that connect them, local officials and other elites have profited handsomely. An indication of the power of this coalition of interests can be seen in the desultory attempt to revise Land Management Law (LML) and raising the costs of requisitioning land from farmers. While the National People's Congress put amending the LML on its legislative agenda in both 2009 and 2010, it was not until November 2012, toward the very end of Wen Jiabao's term as premier, that the State Council executive meeting finally approved a bare-bones amendment to the LML calling for fair compensation to be given for land requisitioned from rural communities for industrial and commercial use. Even then the NPC has dragged its feet in approving the amendment. In contrast, when during the global financial crisis the Chinese central government decided to stimulate the economy, both central and local authorities eagerly embraced the move and borrowed heavily to invest what they what they had been doing all along, namely railroads, highways, subways, and industrial parks, as well as real estate. Local governments are saddled with debts incurred during that stimulus binge.

Energy Efficiency and Emissions Reduction during the 11th Five-year Plan

Yet the hyper growth decade of the 2010s also coincided with a steady decline in the percentage of population that indicated that they were happy. Instead, there has been growing concern about quality of life issues, including food safety, drug safety, and air and water safety. In fact, it was during the era of Hu and Wen that Hu's emphasis on adopting a scientific outlook on development included ecological civilization as a component.

Confronted with escalating environmental costs and a growing number of public protests, the Chinese government announced in 2006 that the nation would seek a 20 percent reduction in energy consumed per unit of GDP, and cut the amount of key pollutants by 10 percent during the 11th Five-Year Plan period (2006-2010). China's Leaders hoped this would "basically arrest the trend toward environmental degradation." But the five-year plan looked quixotic on arrival and in the first half of 2006, energy consumption per unit of GDP actually increased. More vigorous measures in 2007 produced some improvement, but still fell short of targets.

Following the initial setup, Premier Wen Jiabao vowed in March 2007 that the 2010 goals for energy efficiency and emissions were "binding targets." This top-down imperative sparked a frenzy of activity, including more central monitoring of local environmental performance, more environmentally-attuned incentives for local officials, and significantly greater investments to promote energy efficiency and reduce emissions.

Most visibly, the National Development Reform Commission (NDRC) and the environmental administration pursued a vigorous strategy of holding local officials accountable for environmental performance. In 2007, the NDRC signed energy efficiency responsibility contracts with 30 provincial-level governments, and made energy efficiency a compulsory component for projects requiring government-approval. At the same time, the environmental administration created regional monitoring centers so it could independently measure local performance. In March 2008, this administration was upgraded to become the Ministry of Environmental Protection (MEP) and given cabinet status and. The State Council also set standards to hold provincial governments and about 1,000 key firms accountable for their environmental performance.

The MEP immediately sought to wield its newfound power, including public shaming of regions and companies that fail to meet standards. In 2008 the MEP publicly released data on each province's performance in reducing water polluting discharges and sulfur dioxide emissions. One 2009 report singled out water treatment facilities in eight cities (spread across Liaoning, Heilongjiang, Jiangsu, Zhejiang, Anhui, Guangdong, Sichuan, Gansu provinces) and eight power plants for poor performance in treating waste water and removing sulfur dioxide. The facilities named in the report were required to undertake remedial measures by the end of the year. During that period, the errant city was barred from submitting major projects for approval and also lost access to some central government capital funds.

In October 2009, the NDRC announced with fanfare its ranking of provinces based on how much progress they have made in fulfilling the environmental targets. The public ranking (and shaming), coupled with the threat to cut off funds and project approvals, got the attention of local officials. After Yunnan officials found they were lagging behind the national average in the first half of 2009, they quickly decided to begin construction of 43 water treatment plants. In a rare display of the changed ethos, Shanxi Province received widespread praise for its negative growth and campaign against dirty GDP.

The responsibility system has been backed up with major central government funding to invest in treatment facilities and to help shutter pollution-heavy production capacities in iron and steel, paper making, cement industries, and especially small-scale coal mines and power plants. Central government funding for environmental protection rose 33 percent in 2008. In 2008, despite the Chinese economy growing at 9 percent, energy consumption per unit of GDP decreased 4.6 percent from 2007 while discharges of water pollutants and sulfur dioxide also fell. As a result, the declines in both emissions indicators made up for the shortfalls of 2006-07 and are thus on track toward fulfilling those “binding targets.” As time neared for the 2010 targets, some localities even resorted to draconian and unsustainable measures, cutting off electricity supply to entire communities, in order to meet central government targets for energy efficiency.

Yet the limitations of the existing system were also apparent. As the Chinese economy softened during the Great Recession, the Chinese authorities rushed through with a massive stimulus package. In accelerating the stimulus spending, environmental considerations were eased and more projects were greenlighted without going through the requisite environmental impact assessment.

Xi Jinping, Sustainable Development, and the Ascendance of the Environmental Regulation

As Xi Jinping and Li Keqiang became China’s president and premier respectively in March 2013, they pledged to steer the Chinese economy toward a new model, foster domestic consumption, and build a “beautiful China”. In the last two years, China’s leadership has guided public expectations about the Chinese economy to what is known as the new normal, with a target economic growth rate of 7 percent per year for 2015. Highlighting the uncertainty concerning such targets, Premier Li Keqiang has repeatedly noted that the target rate is not set in stone but that actual performance might deviate from the target rate within a certain margin.

While the Chinese leadership have reduced their emphasis on GDP growth rates, they have in the meantime paid special attention to altering the incentives that have propelled local authorities to engage in local developmentalism. In particular, environmental performance has become a major component, at 20 percent in Hebei, in evaluating local officials.

After its initial flurry of action, the MEP trimmed its sails pursuing a high-profile environmental agenda because its actions would generally impinge on powerful interests. Following the 2013 airpocalypse, however, public demands for environmental action increased sharply and would reach its most visible point with Chai Jing’s 2015 documentary “Under the Dome.” Riding on a wave of growing public concerns, the China National legislature approved a revised

Environmental Protection Law (EPL), which went into effect on January 1, 2015. The EPL allows much stiffer penalties against illegal polluters, including hefty fines on a daily basis and criminal penalties and jail time.

To promote more vigorous action in environmental regulation, the Chinese leadership in March 2015 appointed Chen Jining as the new MEP minister, replacing the long-serving Zhou Shengxian on the latter's retirement. Chen, formerly the president of Tsinghua University (Xi Jinping's alter mater), is an environmental scientist by training and clearly has the trust of President Xi. Such trust provides a fountain of political clout for Chen and the MEP.

Chen didn't disappoint. In April 2015, the MEP refused to approve the construction of three dams, including the Xiaonanhai Hydropower dam that was already written into the development plan for Chongqing municipality. The MEP ruling concluded that these dams would threaten the habitat of certain species.

In the same month, the MEP called for public meetings with leaders of various municipalities and public confronted them over their failure to take action against various polluters. The Hebei bureau of environmental protection in turn called in the leaders of smaller cities/counties and publicly reprimanded them. The environmental regulators demanded urgent action within specific time frames and the leaders of the concerned localities promised to respond to the complaints.

As environmental regulators, joined by NGOs and civil society protests, step up their efforts, regulatory costs will thus increase. Even while national leaders seek to boost investment and growth, the vetoing of the dams and efforts to shut down heavy polluters strongly suggests that China's leadership is willing to sacrifice some growth in favor of the environment. Stiffer environmental regulation may very well be a game changer.

Government Reform and Entrepreneurship

The Chinese development model based on cheap labor, cheap land, lax regulation have lost significant momentum. While investment remains important, increasingly Chinese growth must come from reform. Therefore, the new five-year plan will largely fall under the rubric of the two decisions approved by the CCP Central Committee plenums in 2013 and 2014. The Decision of 2013 dealt with comprehensive reforms to enable market forces to play the decisive role in the economy. The Decision of 2014 laid out a plan for the promotion of governing the country in accordance with the law. Lately Xi's guiding principles have been encapsulated under what are called the "four comprehensives", namely, Comprehensively build a moderately prosperous society, Comprehensively deepen reform, Comprehensively govern the country according to the law, Comprehensively apply strictness in governing the Party.

Any serious discussion of the 13th five-year plan will need to first consider the progress in and prospects for implementing the two Decisions, including taking into account the massive campaign against corruption, which has brought down some of the most prominent players (or big tigers) in Chinese politics. While it's still premature to assess the progress of Xi's vast political agenda, in one area a sort of virtuous cycle appears to have emerged and will likely have profound implications for competitiveness.

As noted earlier, China today possesses a hybrid system where the state sector remains substantial and the Party-state commands enormous resources but the market also plays significant role. Under one-Party rule and lack of judicial independence, such a system is prone to the creation of crony relationships.

In my book *Remaking the Chinese Leviathan*, I highlighted the Chinese leadership a decade earlier had come to realize the importance of transforming the government in its functions and quality of service. These efforts were undercut later on as Chinese growth accelerated during the HU-Wen era and the focus of leadership turned to stability maintenance.

With growth slowing down and traditional tools of investment pump priming being of limited utility because of high debt levels and overcapacity in many sectors, the Chinese leadership has turned to the encouragement of entrepreneurship through the creation of free trade zones and the rationalization of government administration to improve transparency and ease registration and other bureaucratic requirements. In fact, a “fever” for mass entrepreneurship (大众创业) now pervades China. In 2014 the number of newly registered businesses grew by 46 percent, partly because of reforms in the tax system (change from business tax to VAT for service firms) and partly because of easier registration processes.

The ongoing efforts to rationalize the government administration will further reduce the burdens on businesses. In the past China’s leadership struggled to reduce the number of approval items and some reforms to reduce perks for government officials and staff, such as curtailing the use of official cars, faltered. In 2014-15, however, sentiment has vastly changed as Premier Li Keqiang seeks to steadily reduce the number of government approval items. The major factor behind the change is the massive campaign led by Xi Jinping and Wang Qishan. As more and more officials are caught in the anticorruption dragnet, officials have come to appreciate how having the powers of approval make their these officials the targets of bribery. In a variety of areas I have examined, there is strong desire by superordinate government departments to eliminate or delegate the powers of approval. Thus the anticorruption campaign has proved to be of fundamental importance to changing the way bureaucrats behave and may well prove to be of lasting importance to the creation of a more nurturing regulatory environment for entrepreneurship. In fact, the persistent and massive anti-corruption drive coupled with the implementation of the 'eight regulations' concerning Party and government work style have sharply curtailed benefits and grey income that many members of the officialdom once enjoyed and have in recent months helped persuade some of them to quit their government jobs in favor of the private sector and entrepreneurship.

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[i] Quoted in Dali Yang, *Remaking the Chinese Leviathan*, Stanford: Stanford University Press, 2004.