

Policy Forum: China's New Model of Growth, Challenges and Progress

Structural Reform for Economic Growth

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Abstract

This article examines the role of reform in maintaining economic growth in the circumstances in which work-age is declining more rapidly than total population. Traditional factor-driven growth can still contribute if reform increases labour force participation, most significantly through easing restrictions on rural–urban migration through reform of the household registration system and other means. The other potential contributor to growth in the new era is reform to raise productivity. This requires more fundamental institutional change, which depends on clear visions of the framework for a modern market economy, encompassing the rule of law and stronger property rights.

1. Introduction

After three decades of double-digit growth, China's economy has now moved into a period of slower potential growth rates known as the 'new normal'. To realise sustainable growth from now on, China must capture dividends from reform. This article analyses progress in deepening the market-oriented reforms that began in the late 1970s. It concludes that the best way for China to capture reform dividends is to further clarify the direction of reform, to promote institutional reforms and to restructure incentive mechanisms to mobilise enthusiasm across all of Chinese society.

The keys that unlocked China's economic miracle over the past few decades were market-oriented reform and opening-up to the international economy. After the 18th National People's Congress of the Communist Party of China (CPC) held in 2012,¹ and especially following the third plenary session of the 18th CPC Central Committee in November 2013, a new agenda for reform was set. This agenda outlined that China should:

- (i) continue to promote improvement and development of the socialist system with Chinese characteristics, and increase social productivity, thereby releasing the creativity across society;
- (ii) promote sustainable and healthy development, and to continue to improve people's wellbeing;
- (iii) maintain the vitality of the socialist system in a context of global interdependence and institutional competition.

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Reform is continuous in China as well as in developed market economies. Globalisation has led to ‘institutional (or system) competition’ (Kasper and Streit 1999) amongst leading economies, which has been sharpened since the 2008 global financial crisis (GFC)

The ability and determination of one country to promote reforms depend mainly on its state capacity. The Irish thinker Edmond Burke argued in his book *Reflections on the Revolution in France*: ‘A state without the means of some change, is without the means of its own conservation’ (Burke 1982, p. 18). A state without such means for change will lose the part of its system that it wants to preserve the most. This is the force driving the reforms in China that are aimed at ‘preserving’ the fundamental nature of the socialist system.

The pursuit of internal reform in a context of intensified global competition provides the underlying logic of China’s reform and opening-up. In the 1980s, paramount leader Deng Xiaoping pointed out that the purpose of reform (at that time) was to establish a solid foundation for sustainable development through the first half of the twenty-first century (Deng 1993).

2. New Features of Reform

Without continuing reform, China could fail to achieve sustainable growth and may even fall into the ‘middle-income trap’. Its contemporary challenges make deepening structural reform an urgent task. Here we highlight new features of China’s reform requirements.

3. The Deep-Water Reform Zone after ‘Pareto Improvement’

After ‘the reform without losers’ in the early years of economic transition (Lau, Qian and Roland 2000), China has now entered a deep-water reform zone with more challenges and difficulties. Multiple deep-rooted social conflicts are compounded by weak social mobility and resistance from vested interests. Little progress has been made on such issues over many years. This can be partly attributed to China’s gradualist approach to reform, in

which relatively easy tasks have been pushed forward and difficult ones put aside. This gradual approach has protected vested interests—allowing private interests to capture benefits through abuse of public power and to impede the general public’s access to the fruits of reform.

Earlier reforms were typically characterised as offering a ‘Pareto improvement’, in which the majority of people benefit and no one suffers. Current reforms, however, require ‘Kaldor improvement’, in which there is coexistence of benefits from a bigger pie with benefits from dividing the pie more equitably. Policy-makers need to consider the likely beneficiaries before, during and after implementation of reform, and give top priority to the interests of ordinary people.

4. Interplay between Top-Level Design and Grassroots Innovation

Four major problems need to be addressed by top-level design.

First, it is important to look at the overall picture. Reform is a systemic project, in which opportunities and challenges are entangled, and piecemeal adjustment and repair cannot work. There must be comprehensive systemic reform and improvement in all fields. That requires overall planning of the reform process.

Second, innovations at the grassroots level should be consistent with the general direction of reform. Third, there is a need to define the boundaries of the possible. Fourth, the deadlock created by vested interests must be broken. In the deep-water zone, top-level leadership may be needed to break vested interests’ resistance and add new momentum to reform.

At the same time, innovation at the grassroots level should be encouraged. Problems that are difficult to solve in theory can often be addressed in practice. Local experimentation can expand knowledge of what is possible and desirable. Innovation at the grassroots level is of great importance for the development of theory. It can help to achieve practical results, including in institutional innovation.

5. Legal Basis of Reform

Reform should be promoted under the rule of law and the rule of law needs improving in the process of reform. There must be a legal basis for reforms. Problems incurred during the passage of reform should be solved only within the framework of the rule of law.

The ultimate goal of breaking barriers to reform is to establish a set of new, stable and efficient laws and regulations. China has now integrated itself much more deeply into the global system, where regard for the rule of law is necessary for the common achievement of human civilisation. China's promotion of reform built on laws can contribute to a favourable international environment.

6. Role of Government and Ensuring a Level Playing Field

There is an extensive literature on the role of government in economic development. The concept of the 'developmental state', refers to government playing an active role in promoting economic growth through strong and direct intervention, including extensive regulation and planning (see Johnson 1982; Woo-Cummings 1999). Governments in East Asia, including China, typify the developmental state.

Traditional industrial policy can play a role during economic catch-up because the main lines of development are relatively simple and the government can provide information on directions for investment and development. Government can mobilise resources and promote knowledge of relevant technologies (Developing countries rely on 'importation' for more than 80 per cent of their new technology; Manyika et al. 2015). As the advantage of backwardness progressively shrinks, however, uncertainty about appropriate technologies increases and the government's ability to collect information and make appropriate decisions declines.

As the economy develops a more mature industrial system and markets, the above policy distortion will increasingly inhibit innovation and the sustainability of growth (Zhang, Li and Li forthcoming; Bardhan 2016). In the new

circumstances, the more seeds of innovation that are sown, the more novel ideas sprout. It becomes necessary to pay more attention to competition policy and to let market forces play a greater role in innovation and related incentives.

With the Central Committee having clearly outlined the general direction of China's reform, the challenge now is how to achieve practical results. Some basic theoretical questions remain unanswered. The recent fierce debate on industrial policy in China shows that consensus has not yet been reached on the issue of the market–government relationship.²

Defining the boundaries of the market and government is a practical matter. The government cannot be absent from its essential functions., for example, providing public goods, fairness, justice and good governance.

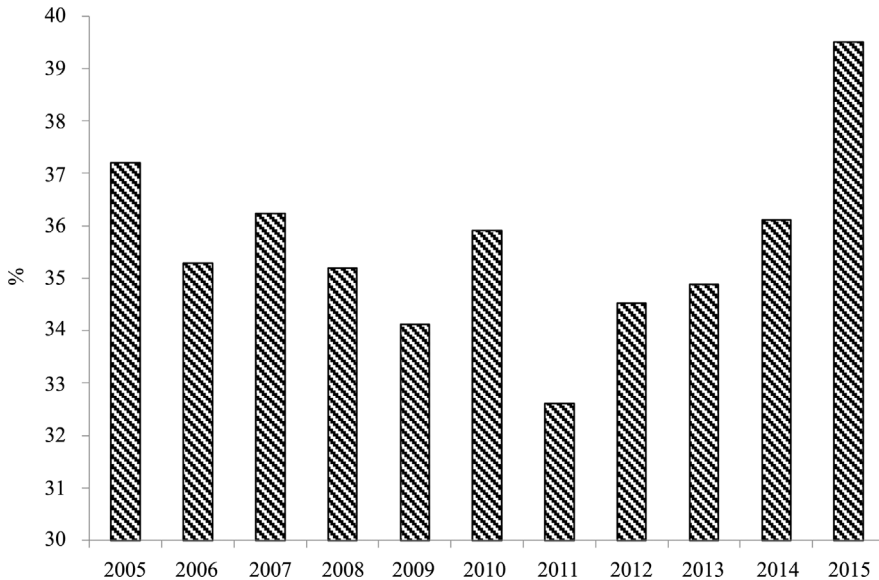
The state occupies an exceptionally large place in contemporary Chinese economic development, through regulatory intervention and state ownership of enterprises. The role of the market in resource allocation has greatly expanded since the early 1990s. But the role of state-owned enterprises (SOEs) began to rise again from 2011 (Figure 1).

In 2015, the government's sovereign net worth reached about RMB100 trillion (Figure 2). The proportion of general government in national net wealth is close to one-quarter, in comparison with Germany and Japan, where this ratio is less than 1 per cent, and the United Kingdom and the United States, where it is negative (Figure 3).

According to Detter and Folster (2015), net sovereign wealth is almost US\$75 trillion. This figure does not include large amounts of non-commercial assets, such as natural resources and assets held by China's science, education, culture and health institutions. Reforming the government's role in resources allocation, as well as greater efficiency of resource use is an important aspect of future reforms.

To address problems of market price distortion, inefficient allocation of resources and insufficient supply of public services, it is necessary to shift allocative decisions away from the state and towards market mechanisms.

Access to, and use of, natural resources should be based on a property rights system. In

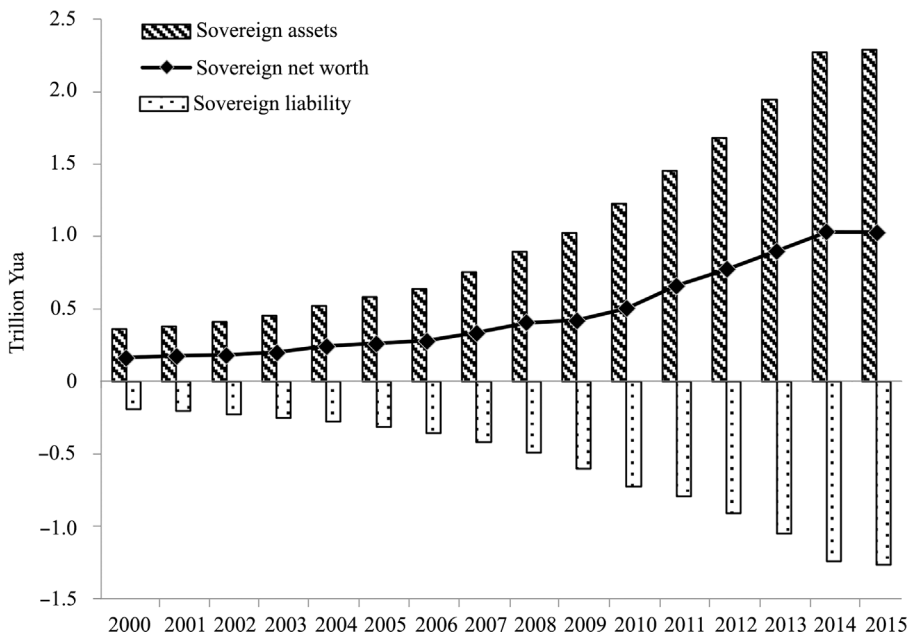
Figure 1 Trends in the Relative Size of State-Owned Assets (as a percentage of total assets in the corporate sector)

Sources: National Bureau of Statistics of China (various years); authors' estimates.

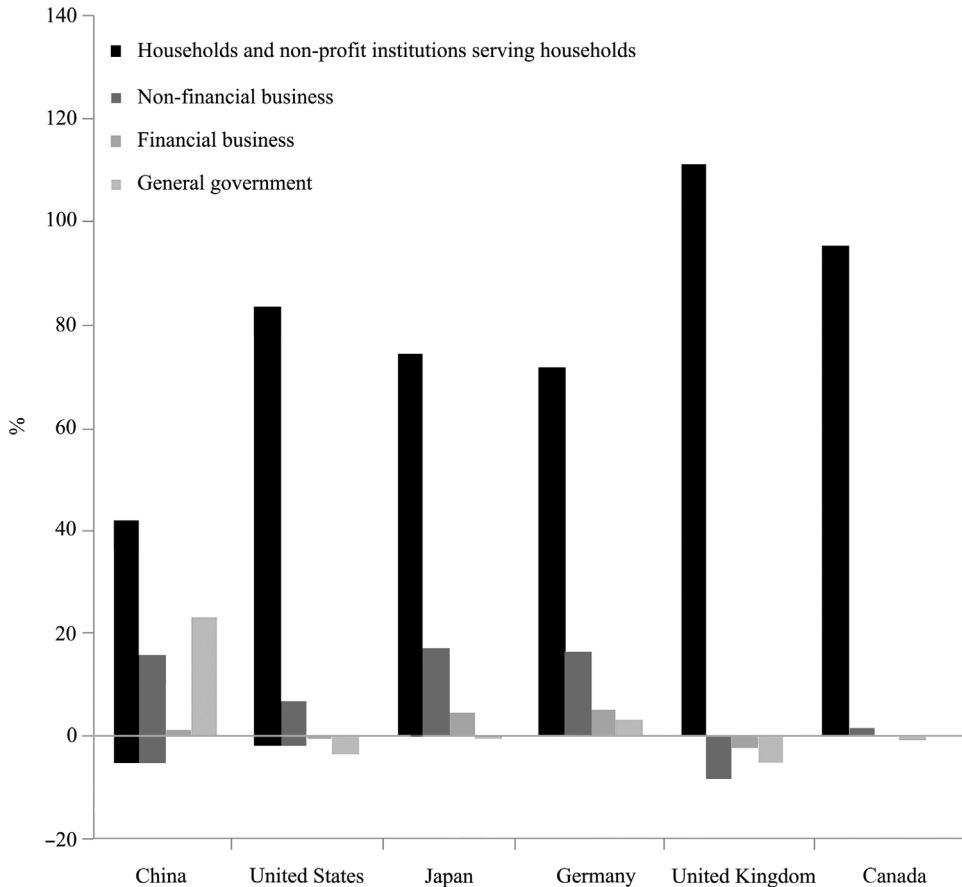
China, the law clearly stipulates that all natural resources—such as land, minerals, water, forests, mountains, grasslands, wasteland, sea areas, uninhabited islands, beaches and so on—are owned collectively. A clear property rights

system should be established and the administration of use improved.

The government should focus its scarce resources on industries and infrastructure projects that relate to national security,

Figure 2 China's Sovereign Assets, Liabilities and Net Worth (RMB trillion)

Sources: National Bureau of Statistics of China (various years); authors' estimates.

Figure 3 International Comparison of China's Net Worth Structure, 2015 (per cent)

Notes: Data for China are from 2013 and from 2014 for other countries. For Canada, non-financial and financial sectors have been consolidated. General government assets in China include state-owned business assets, non-business assets, natural resource assets, foreign assets, social security funds and government deposits at the central bank.

Sources: National Bureau of Statistics of China (various years); authors' estimates.

foundational infrastructure and people's livelihood.

Where government remains an owner of commercial enterprises of systemic importance, assessments need to be made on the proportion of state ownership that is necessary to secure public objectives, and exit mechanisms defined for state-owned capital. State enterprises should be subject to market competition wherever this is possible.

Where government owns commercial assets, policymakers should clearly define the different functions of the government as a capital owner and as an industry regulator.

Three changes are necessary to establish the level playing field that is essential to the vitality

and efficiency of the economy in the 'new normal' era.

Policymakers need to break local market barriers and promote the mobility of goods and production factors across regions. This will aid the formation of a truly unified domestic market.

It is necessary to tackle the administrative monopoly of SOEs. A study by Li, Liu and Wang (2014) found that after large-scale reform of SOEs in the late 1990s Chinese industry formed a vertical industrial structure. SOEs continued to dominate and monopolise some major upstream industries (including energy, finance and telecommunications). The majority of downstream industries (the manufacture of

consumer goods, hospitality, entertainment and other consumer-oriented services) came to be dominated by private enterprises. Private enterprises in downstream industries grew by making full use of China's abundant and cheap labour and taking advantage of China's accession to the World Trade Organization (WTO) in 2001. SOEs, with their monopoly on upstream products, have been able to extract rents from the competitive part of the economy. Currently, the source of SOEs' monopoly is mainly preferential access to resources and markets, government procurement opportunities and so on. Breaking the administrative monopoly of SOEs is necessary to establish a level playing field.

7. Improving the Property Rights Protection System

In November 2016, China issued 'The Opinions of the CPC Central Committee and the State Council on Improving the Protection System of Property Rights and the Protection of Property Rights in Accordance with Law'.³ The document stresses that the property rights system is the cornerstone of the socialist market economy and that the protection of property rights is required in the socialist economic system.

Many studies from outside China suggest that reform of the property rights system has been largely ignored (Murphy, Shleifer and Vishny 1992; Young 2000; Brandt and Rawski 2008). Others recognise that China's property rights system has many distinctive features that are open to change. In an economy dominated by public ownership, the contracting out of property use rights (exemplified especially by the rural household responsibility system) has emerged from the abstract and often ill-defined ownership of 'whole people' or 'collectivity'. Effort has been made to respect private ownership of capital, labour, technology and entrepreneurship. New forms of private property rights have been recognised. The need for transfers of property to preserve and increase property values has seen the emergence of market transactions. Contracts can be concluded for

transfers of various types of property rights within the framework of the shareholding system (Zhou 2010).

The remaining problems define a reform agenda. First, public property rights need to be defined and protected. Second, private property rights need to be defined and protected. China's planned economy has long discriminated against private ownership. Policymakers therefore need to break the ideological constraint of 'public versus private' and strengthen the equal protection of property rights for all kinds of economic organisations and agents.

Third, intellectual property rights must be protected. Further work is needed to refine the laws and regulations relevant to intellectual property rights. Enforcement of intellectual property rights protection is essential, as is eliminating arbitrariness and selectivity in enforcement.

8. Promoting Reform Plans

For a long time, there has been a false view both in China and abroad that economic growth has to be sacrificed to achieve breakthroughs in reform. For government departments or local governments, stimulus strategies on the demand side are usually visible and deliver rapid results. Structural reform of the supply side is invisible and the results distant. There is an inherent bias in favour of demand expansion over reform.

The incentives for reform of various agents that are important in the decision-making process are often incompatible. Many reforms generate costs and benefits that need to be shared appropriately across levels of government and centres of power (Rajan 2004).

There is a tendency for some officials to focus only on what can be measured—crucial for performance assessment and promotion—rather than on deep reform of institutions and mechanisms.

There is a tendency to avoid important problems and focus on the trivial, simply because the trivial ones are easier. This protects vested interests.

9. Restructuring the Incentive Mechanism

The CPCs have taken a tough stance on corruption and have gradually established rules and regulations since the 18th CPC National Congress and, particularly, the third plenary session of the 18th CPC Central Committee. This should now be supported by an appropriate incentive mechanism, which is still in the making.

In the past four decades, inter-regional competition and local vitality have supported China's economic success. But the same competition has had adverse impacts, including over-investment, over-capacity and local protectionism. Local competition in China has centred excessively on GDP growth. Policy-makers should focus on the type, quantity and quality of public goods and services to assess the performance of local governments and, in so doing, foster a new type of local competition for this new phase of development.

China should improve incentive mechanisms so that the gains of entrepreneurs are matched with their contribution to innovation and management, as well as with their responsibilities and risks. Although the entrepreneurial spirit—especially the spirit of innovation—often manifests as unusual thoughts and behaviour, as long as these are within legal boundaries they should be respected. Fundamentally, the Chinese Government needs to establish a legal system that protects the rights of entrepreneurs and recognises their contributions.

Structural reform needs broad support in the community. It is necessary to establish institutional mechanisms so the dividends of reform and the fruits of development can be shared equitably among all people.

10. Achieving Sustainable Growth through Reform Dividends

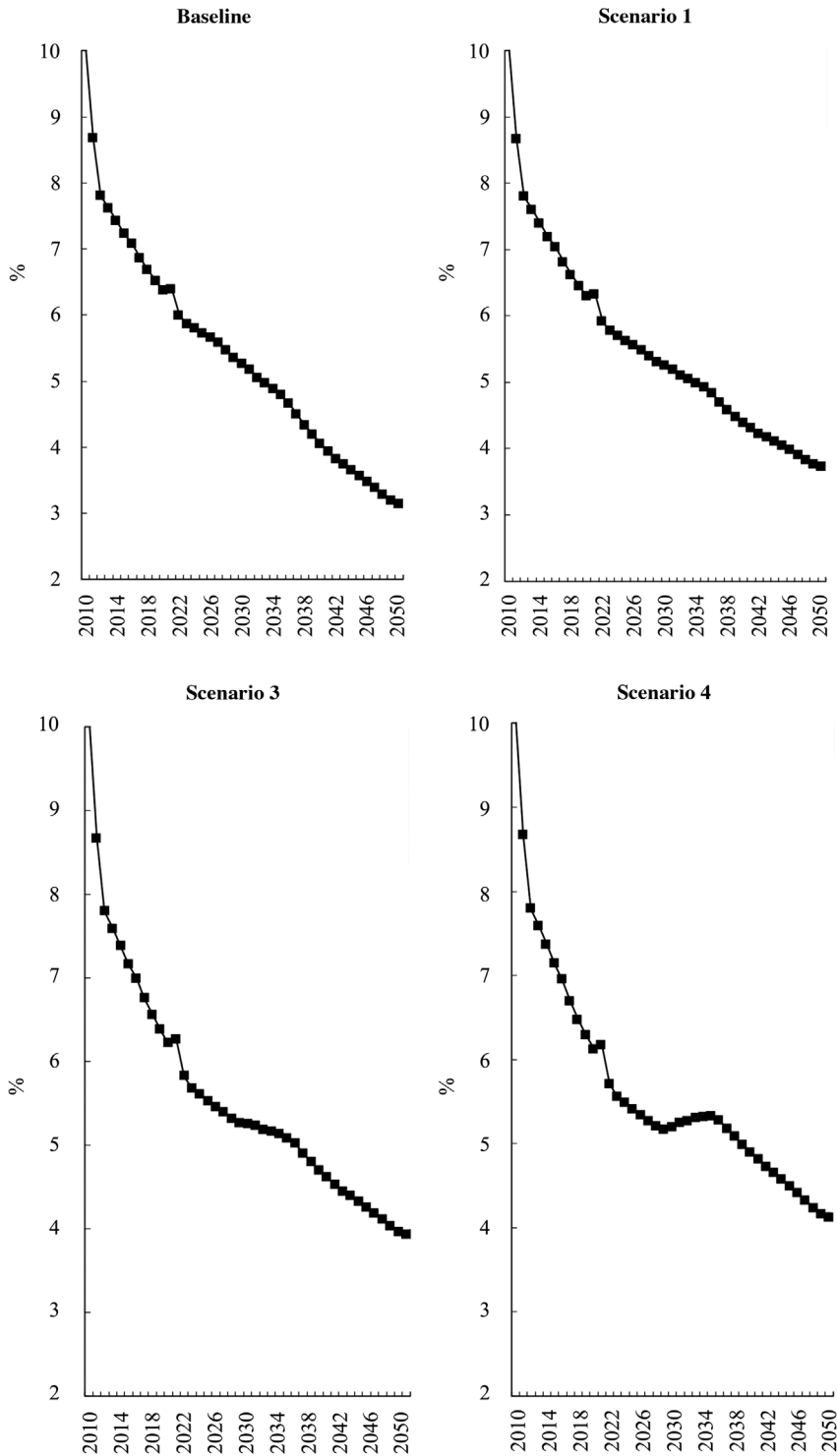
There are two ways to increase the potential growth rate. The first is to maintain the traditional growth momentum. This now means focusing on expanding the potential supply of labour through increasing labour force participation. The second is to develop

new drivers of economic growth. This is mainly about increasing human capital accumulation and total factor productivity (TFP) growth. Both these sources of economic growth generate reform dividends.

Almost all the factors causing China's economic slowdown can be attributed to the fading of China's demographic dividend, now that there is no longer an unlimited supply of new (and low-cost) labour. The working-age population (15–59 years) is now decreasing. The only way to increase the potential supply of labour is to increase the labour participation rate. Simulation shows that across the period 2011–22, if the labour participation rate of the non-agricultural sector increases by 1 per cent per year, China will increase its potential growth rate by 0.88 per cent (Cai and Lu 2013). The most important measures to improve labour force participation include reform of the household registration system and improvements in urban public goods and services, both of which would help to stabilise and expand the employment of migrant workers in the urban economy and non-agricultural industries.

Population policies could increase the total fertility rate and establish a balanced population age structure in the future. Chinese President Xi Jinping has asked the country to 'stand on the strategic height of the long-term development of the Chinese nation and promote the balanced development of the population'.⁴ According to international and Chinese experience, a decline in fertility is associated with economic and social development, and fertility policy itself plays only a marginal role in most cases. For 35 years, from the early 1980s, China implemented its 'one-child' family planning policy. Recent reforms to this policy now allow two children per family. It is hoped this adjustment to fertility policy is able to at least slow the decline in the fertility rate, which is currently believed to be about 1.5—at best it may raise it over time. Policy simulations show that if the fertility rate increases to 1.8 from the benchmark rate of 1.6, the potential growth rate in the period 2036–40 could be increased by 0.2 per cent (Cai and Lu 2016).

Figure 4 Supply-Side Structural Reform and Growth Scenarios



Source: Cai and Lu (2016).

Reform aiming to lift fertility should not be limited to reform of the one-child policy. Reducing the financial burden and opportunity cost of raising children would encourage people to have more children.

It is crucial to maintain rapid human capital accumulation. Other East Asian experience demonstrates the importance of human capital accumulation for growth at China's stage of development. One of our research simulations (Cai and Lu 2016) shows that improved education and training could increase China's future potential growth rate by about 0.1 per cent. If the quality of education is taken into account, the effect of human capital on economic growth is greater (Manuelli and Seshadri 2005).

Additional policy efforts should be made to raise TFP growth. The theoretical literature and empirical analysis (for example, Cai and Lu 2016) show that although an increase in the labour participation rate helps boost the potential growth rate, that impact diminishes over time. By contrast, the contribution of TFP growth to potential growth is not only immediately effective, but also endures over the long term. China's economy is increasingly dependent on scientific and technological innovation to maintain its sustainability. There is still plenty of room to improve the efficiency of resource allocation by eliminating institutional barriers. Our simulation shows that if the average annual TFP growth rate increases by 1 per cent over 2011–22, the rate of potential growth increases by 0.99 per cent over the same period (Cai and Lu 2013).

We considered different scenarios on the hypothetical contribution of reform of the household registration system, the education and training system, SOEs and population policies, as well as changes to the labour participation rate, human capital accumulation and TFP. We find that different intensities of reform produce radically different growth trajectories in both the short and the long term (Figure 4).

In sum, as China's economy transitions into the slower 'new normal' growth—characterised by its market-oriented reform program—it encounters new challenges and opportunities.

The achievement of sustainable growth via the promotion of reform assumes primary importance. We conclude that the best way for China to capture reform dividends is to further clarify the direction of its reform program, promote pragmatic reforms and restructure incentive mechanisms to mobilise enthusiasm across all of Chinese society.

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Endnotes

1. See Hu Jintao's *Report at 18th CPC National Congress*, held in November 2012. For an English translation of the report, see <news.xinhuanet.com/english/special/18cpcnc/2012-11/17/c_131981259.htm>.
2. See a news report on the debate between Yifu Lin and Weiyang Zhang, two economists of influence in China. Available from <finance.sina.com.cn/roll/2016-09-26/doc-ixwvwmf2320320.shtml> (in Chinese).
3. See <<http://news.sina.com.cn/o/2016-11-28/doc-ixfya wxa2944356.shtml>> (in Chinese).
4. See <health.people.com.cn/n1/2016/0819/c398004-28648312.html>.

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