

# Development, State Capacity and Governance: Lessons for China?

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# Background

Various economic, political and social forces shape development

- ▶ emphasize the role of the state

General perspective and implications for China

- ▶ draw on recent research with Tim Besley (LSE)
- ▶ book and a number of papers
- ▶ comment on China as an outside observer

# Roadmap

1. Development clusters
2. China's performance and governance
3. China's growth challenge
4. China's responsiveness challenge
5. Final remarks

# 1. Development clusters

Why are some countries rich and others poor?

- ▶ common starting point for studies of development in economics

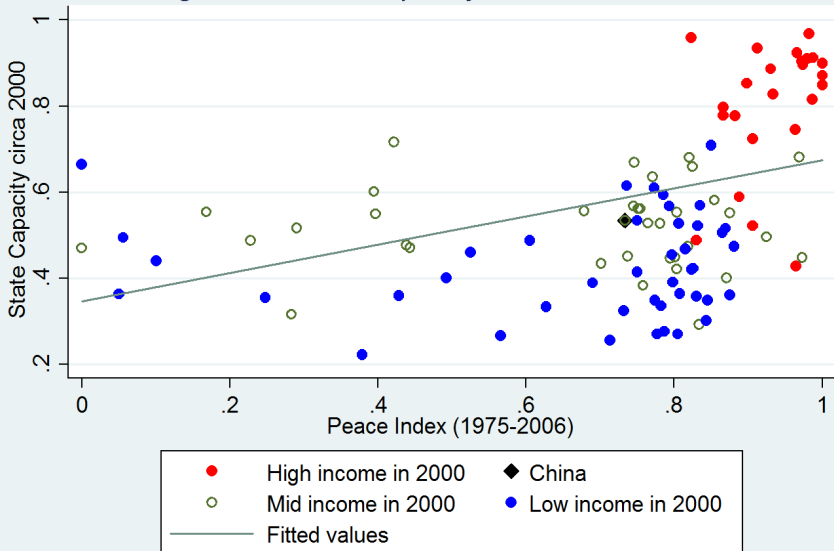
But development is about more than income

- ▶ countries with massive poverty often have weak states and societies marked by violence
- ▶ developed countries: high income, strong states with working institutions, little conflict

Multidimensional issue – why do income, institutions and violence cluster?

- ▶ see Figure 1

Figure 1: State Capacity, Peace and Income



# State capacity clusters

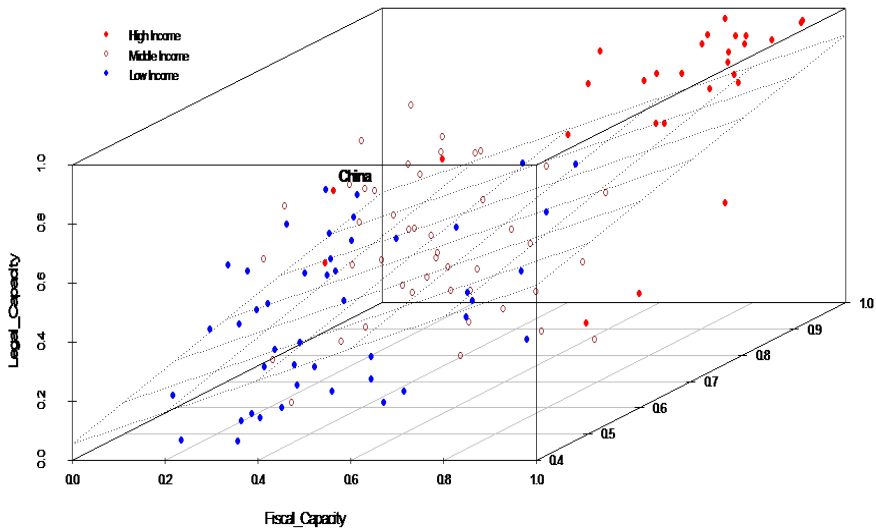
Ruling governments invest in different forms of state capacity

- ▶ the ability to support markets: legal capacity (independent courts, competent judges, registers)
- ▶ the ability to supplement markets: collective capacity (systems to provide health, education and income support)
- ▶ the ability to raise revenue: fiscal capacity (structures to monitor and enforce tax collection)

These different state capacities are also strongly correlated

- ▶ see Figure 2

Figure 2: Three Dimensions of State Capacity



## Why do we see these clusters in the data?

Existing state capacities reflect purposeful investments made in the past

- ▶ investments mutually reinforcing, creating virtuous (or vicious) circles
- ▶ e.g., greater ability to support markets (legal capacity) expands tax base, this makes investment in ability to raise revenue at given tax rate (fiscal capacity) more attractive
- ▶ same political, economic and social factors drive investments in all state capacities
- ▶ important driver is motives embedded in governance institutions

Income and state capacity may also develop via positive feedbacks

- ▶ another source of virtuous circles



# Governance institutions

Political and judicial governance have different dimensions

(i) Accountability – who appoint political leaders and for what?

- ▶ voters, or a more narrow group – the electorate
- ▶ accountable leaders have stronger motives to adapt policies and investments in state and economy to the performance criteria

(ii) Representation – who can take part in political decisions?

- ▶ special interests may rule, at expense of common interest, if major groups not well represented

(iii) Political stability – how long are horizons of ruling groups and leaders?

- ▶ investments in state and economy may depend on time until replacement – or expected promotion

## Governance institutions (continued)

(iv) Constraints on power – how freely can political leaders act?

- ▶ with instability and few constraints, ruling group may not invest for fear of being replaced (and exploited)
- ▶ with stability and few constraints, a ruling group may invest in the state to benefit its own special interests, not common interests
- ▶ market support, e.g., by legal protection of property, may not be credible if judicial institutions controlled by ruling group

(v) Task assignment in multi-level states – how is power allocated across levels?

- ▶ imbalance in economic and political decision making may impair leaders ability to act
- ▶ imbalance in taxation and spending may slow down investments in the state by removing virtuous circles

### 3. China's performance and governance

Unprecedented growth performance after 1970s reforms

- ▶ transition from low to mid-income status in very short time

State capacity has also been built, but picture is mixed

- ▶ legal capacity – as property rights protection and contract enforcement – improved, but still midway in international rankings
- ▶ collective capacity – health and education provision – improved, but provision uneven across provinces and across urban and rural areas
- ▶ fiscal capacity – ability to raise revenue – quite low: less revenue raised than in rich states despite comparable tax rates

# Governance – Accountability

Accountability of CPC leaders not downward to citizens, but upward to leaders at higher level who decide on promotion

- ▶ research shows that personal connections play important role
- ▶ but so does economic performance: GDP-growth
- ▶ upward accountability for performance give party secretaries (governors) at province, prefecture and county levels strong motives to boost growth
- ▶ yardstick competition with other leaders at same level of government also spurs local protectionism

# Governance – Representation

Virtually all political power rests with CPC

- ▶ members from different segments of society with attempts to foster a consensus
- ▶ membership only 6-7% of population: party still a governing elite
- ▶ membership privileges and power monopoly pose risks for misuse of power (corruption)

## Governance – Stability

The party adopts a long time horizon and stability a main goal

- ▶ reforms have regulated leader appointments, but leader horizons differ by level of government
- ▶ common horizon is 10 years, to retirement, at central level, but typically less than five years, to promotion decision, at subnational levels
- ▶ this, and performance evaluation, give leaders strong motives to boost short-run (province, prefecture or county) growth by massive investments

## Governance – Constraints on power

Few constraints on executive power of CPC leaders at *each* level of government

- ▶ leaders can freely pursue their goals, given the policies they control
- ▶ raises risk that power is misused, especially by non-promoted regional leaders
- ▶ judicial independence can be circumscribed by party intervention at each level
- ▶ horizontal control stifles vertical control from center – the so-called matrix muddle

## Governance – Task allocation

Political power centralized but – since reform era – most economic policies decentralized

- ▶ not only strong motives, but strong ability for regional leaders to pursue their goals
- ▶ reinforces ability to boost growth for promotion-seeking leaders, and to misuse power for non-promoted leaders
- ▶ also reinforces the matrix muddle

Centralized taxation but decentralized spending

- ▶ gap between spending and tax revenue for low-level governments, partly filled by transfers and "hidden borrowing"
- ▶ but also by revenue from land sales and leases
- ▶ motives weak to build regular fiscal capacity, but strong to build local infrastructure that raise land value for new firms: contributes to growth motives, may have negative spillovers on other regions
- ▶ positive feedbacks between collective and fiscal capacity investments weak or absent



## 4. China's growth challenge

China's growth performance in last three decades is unparalleled

- ▶ growth by capital accumulation and structural transformation from agriculture into manufacturing
- ▶ sustained by high savings rate, cheap state credit to SOE, and public infrastructure investment
- ▶ driven by decentralized policies and local leaders' career concerns

But this growth model may be running out of steam

- ▶ investment rate of 50% will run into decreasing returns, and/or demands for higher consumption
- ▶ higher wages run into competition with poorer nations in South and East Asia (Africa)
- ▶ falling real-estate prices may spell trouble for large state banks that dries up cheap credit (like in 1990s Japan)

# Can China avoid the middle-income trap?

Since 1960, only four economies (except oil states) – Greece, South Korea, Slovenia and Taiwan – entered group of 40 with highest per-capita incomes

- ▶ clear goals to transform economy towards innovation and more advanced sectors in 12th Five-Year Plan, and recent Reform Manifesto
- ▶ reshape coastal regions from "world's factory" to a place higher up the value chain: high-end manufacturing and services, with more R&D and patenting

Can such structural change be facilitated by higher state capacity and governance reforms?

## Managing structural change

Rapid structural change creates winners (losers) new (old) firms and their workers

- ▶ losers demand protection and subsidies, may try to block entry and innovation
- ▶ unemployment in certain regions and among old workers creates social problems – can be managed by stronger collective capacity for income support
- ▶ losing economic elites may not protest in street, but use political influence to block entry and transformation

Existing governance may reinforce these problems

- ▶ strong upward accountability for GDP-growth may align local leaders and vested interests in old industry – "cementing" gives immediate growth in leader's region, while "patenting" pays off only in long run and maybe elsewhere
- ▶ a reformed promotion system would help

# Support innovation by legal capacity

Innovation requires – directly and indirectly – higher legal capacity

- ▶ reliable protection of intellectual rights raise incentives for domestic, or foreign, innovators to invest in new products and processes
- ▶ transformation requires financial markets with better investor protection – equity and venture capital needed to finance new innovative start-ups
- ▶ only better courts and more educated judges can guarantee both types of protection

## Legal capacity solution hinges on governance

- ▶ Credible protection of innovators and investors requires delegation to courts independent from existing elite influence and local party intervention
- ▶ calls for stronger constraints on executive power, monitored and enforced by other independent institutions
- ▶ such reform would have beneficial side-effects by disciplining local leaders, who resist the rule of law for personal gains from corruption
- ▶ may also facilitate vertical control by diminishing the matrix muddle

## Building stronger local state capacities

With China's extensive policy decentralization, stronger state capacities have to be built locally

- ▶ better balance between taxation rights and spending obligations may stimulate virtuous circles, where investment in legal capacity fosters investments in fiscal and collective capacity
- ▶ constraints on local executives or more equal representation – perhaps from elections at levels above the village – may stimulate investments in fiscal and collective capacity by more widely shared benefits from government spending in population

## 5. China's responsiveness challenge

Aside from sustaining economic growth, China's leaders have emphasized maintaining social stability and avoiding internal violence

- ▶ ultimately, this requires an adequate response to social problems, especially as living standards reach a certain level
- ▶ some emerging problems – as inequality or pollution – are largely side effects of rapid growth
- ▶ others – as aging – reflect longer-term trends
- ▶ tackling these problems involves building state capacity and is facilitated by governance reforms
- ▶ some of the issues discussed in recent Reform Manifesto

# Inequality

Inequality in China has gone up fast since late 1970s

- ▶ ratio of urban to rural income is about 3 to 1 – large inequality also in access to health and education
- ▶ vertical income inequality at Latin American level, much above Europe and North America
- ▶ dealing with inequality is important to preserve social and political stability
- ▶ classical method is progressive taxation, and financing health and education by broad-based taxes
- ▶ if such redistribution not carried out, for lack of fiscal capacity, demands may arise for costly action such as expropriation



## Dealing with inequality

In most nations, central government does bulk of redistribution, but China's size and decentralization implies a good share of policy at province level and below

- ▶ little fiscal capacity at subnational levels of government
- ▶ no control over tax rates or broad tax bases
- ▶ need to decentralize parts of taxation to match responsibility for health and education
- ▶ room for virtuous circles in collective and fiscal capacity, when same government controls social spending and the taxes needed to finance it

# Pollution

China has quickly mounting pollution – carbon and chemicals – problem with major threats to human health and physical environment

- ▶ investment-led old-style growth major culprit: part of solution is re-orienting China's growth strategy – a double dividend of the innovation reforms
- ▶ career concerns of local officials magnify the problem – pollution more than proportional to growth for those striving for promotion
- ▶ in theory, pollution is simple to fight with environmental taxes and government regulation of energy use and production
- ▶ in practice, the problem is to pass such policies and implement them against the desire of vested interests

## Dealing with pollution

How mobilize pressure for action from those hurt by pollution to balance resistance from those benefitting from polluting?

- ▶ central regulation simpler if provinces, prefectures and counties monitored by independent government bodies and rules enforced by independent courts – cf. the governance reforms discussed earlier
- ▶ alter motives for growth-centred local leaders is again key – needs credibly restructured promotion criteria
- ▶ another way is more extensive governance reforms, making leaders downward accountable to the local population by elections above village level
- ▶ people on ground better informed about and more sensitive to local pollution than central leaders, more so if informed by independent local media and benchmark comparisons with neighboring localities

# Aging

China has a rapidly aging population with growing needs for health care and income support

- ▶ China's spends less on health than other middle income countries and has a weak social safety net
- ▶ at the same time, family support dwindles due to migration and one-child policy
- ▶ most responsibility at lower levels of government

Once again, run into systemic and governance issues

- ▶ to help the old, investments needed in collective state capacity
- ▶ part of responsibility for old-age spending could be transferred to central (or provincial) level
- ▶ current growth orientation of local leaders does not promote investments in collective capacity, neither does imbalance between taxation and spending assignments
- ▶ local leaders would give greater weight to interests of older people, if they could express these in local elections

## General lessons

To meet the responsiveness challenge, and maintain social stability, China's governance institutions need reform

- ▶ weaker upward accountability than in the current promotions system to turn attention of local leaders from economic growth towards other economic and social issues
- ▶ dealing with issues like pollution would be facilitated by stronger judicial oversight by independent courts and clearer distinctions between executive and legislative bodies
- ▶ responsiveness may be fostered by local elections, where citizens can directly express their desired tradeoff between economic growth and other issues
- ▶ more local freedom to set tax rates and use broader tax bases would better match spending mandates and emerging needs

## 6. Final remarks

Development is a multidimensional process where income growth interacts with the buildup of different state capacities

- ▶ governance institutions are key to building state capacities, maintaining economic growth, and responding to other economic and social issues
- ▶ China may be at a critical juncture to reform its set of governance institutions, which might have served well in period of rapid industrialization and growth
- ▶ in earlier reform waves, central leaders have been bold and farsighted, which will be needed to embark on a path of governance reform