Development, State Capacity and Governance: Lessons for China?

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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

- High Income
- Middle Income
- Low Income

China
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 viscous) 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 selectorate
  ▶ 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
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 "worlds’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