China's Reform Imperative

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From 2001 to 2009, he served at the US State Department as Deputy Assistant Secretary of State for South Asia (2007–2009), Deputy Assistant Secretary of State for Central Asia (2006–2007), Member of the Policy Planning Staff with principal responsibility for East Asia and the Pacific (2001–2006), and as an adviser on China to Deputy Secretary of State Robert B. Zoellick, with whom he worked closely in the development of the US-China senior dialogue.

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Introduction

After thirty-five years of unprecedented growth, China's prevailing growth model is running out of steam. Predicated on investment in fixed assets, such as infrastructure, and, to a lesser extent, reliance on exports, the economy is delivering diminishing returns to the Chinese people. For this reason, establishing a new, and more sustainable, growth model is perhaps the most intense challenge now facing the eighteen month-old administration of President Xi Jinping.

Bluntly put, China's economy confronts severe headwinds that are likely to jeopardize the remarkable gains of recent decades unless the government makes serious policy and institutional changes. Longstanding resource-intensive and labor-intensive growth looks increasingly untenable as environmental degradation, resource constraints, labor shortages, and demographics converge to force Beijing to focus not just on *whether* the economy grows but *how* it grows. China is, to be sure, more prosperous in the aggregate than in 1978, yet that prosperity has become highly unbalanced and unevenly distributed.

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To achieve a more broad-based prosperity—the kind of wealth that separates advanced economies from developing countries—China will need to once again embrace bold change. The good news is that Xi's team has forged consensus around the idea that significant structural change is the only way to free the Chinese economy from the dreaded "middle-income trap" into which so many other developing countries have fallen. For Xi and his team, it is clear, China must reform its way toward a new era of enduring prosperity.

Of course, economic reform of this magnitude and complexity is not an event, but rather a process. It is the work of years, and potentially of a generation. So the new leadership has given itself until 2020 to achieve some of the most difficult and important reform objectives unveiled at the Chinese Communist Party's (CCP) landmark Third Plenum in November 2013.

In the following series of three essays, originally published in *Foreign Affairs* magazine over a one-year period, we dissect China's reform ambitions from several angles.

The first piece, written nearly eight months before the Plenum, offered a cautiously optimistic case for significant and enduring economic reforms. In the

second piece, published a month after the Plenum, we offered an interpretation of what these reforms will mean for China. Noting the CCP's declaration that the market must henceforth play the "decisive" role in allocating resources, we argued that reshaping the state's role will, in fact, be the central challenge facing the entire reform agenda. Finally, our third piece, published several months later, argued that not only must the state's role be reshaped but the relationship between various levels of government in China—that is, whether the central or local governments perform precisely which functions—also needs to be rejiggered if reforms are to be executed effectively.

Taken together, these three essays are meant to offer a comprehensive look, albeit from a high level, at China's economic reform opportunities and challenges.

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The Rise of China's Reformers?

With China's political transition now complete, the country—and the world economy—has been left with a pressing question: Does the new team in Beijing have the vision and the political will to revive stalled yet crucial economic reforms? Few observers have been optimistic about the answer.

A growing chorus of pessimists, in China and elsewhere, has coalesced around three central arguments. The first group, call them the "economic cynics," argues that the bar for reform is just too high. This is because several underlying economic problems, including a real estate bubble, have worsened at precisely the moment that China's economic growth has slowed. Chinese officials' traditional solution to economic slowdowns—accelerating exports—has become harder in light of declining demand in advanced industrial countries.

Photo: World Bank/Curt Carnemark

What is more, these pessimists argue, even if China's new leaders want to undertake bold reforms, economic problems have become so dire that they will overwhelm the new team's ability to forge consensus around a fresh approach. According to China's National Audit Office, for example, provincial, county, prefectural, and municipal governments are some 11 trillion yuan ($1.8 trillion) in debt. This problem could lead to another round of exploding bad loans that would constrain the banking sector and forestall financial sector reforms.

The second group, call them the "social doomsayers," argues that bad policies and poor governance are fueling unprecedented social unrest—with more than 100,000 protests taking place each year by some estimates. This group insists that since preserving political stability is Beijing's top priority, the government will avoid undertaking reforms that risk short-term economic dislocation and might further exacerbate social discontent.

According to this group, China's leaders are caught in a bind: if they reform too much, they risk opening the floodgates to more protests; but if they reform too little, they risk leaving intact the underlying causes of the unrest. Two oft-cited examples of the latter dilemma are environmental degradation and land

seizures by local officials, which have been the major reasons that ever more Chinese have taken to the streets.

But local governments are still focused on economic growth at all costs rather than cleaning up the environmental costs of this growth. Unless Beijing devolves independent fiscal authority to provincial and municipal governments—a very tough reform, by any standard—and changes the political incentives that reward growth above all other objectives, local officials will continue to seize and sell land to developers to raise revenue. So under either scenario, this group insists, political caution will constrain the new leadership's options for reform.

The final group, call them the "political doubters," questions the new leadership's resolve to overcome powerful vested interests that will resist reforms, especially among China's state-owned enterprises. These powerful corporate players, this argument goes, will obstruct the leadership's well-intentioned goal of boosting household incomes, defeating efforts to force state firms to pay more dividends that can be redistributed into social welfare programs.

None of these three camps is entirely wrong. Each describes a certain facet of the considerable challenges China's new leaders now confront. But their pessimism ignores a central lesson of China's recent history—one that undoubtedly resonates with at least some members of the new policy team: reform is possible when the right mix of conditions comes together at the right time.

Why Economic Reform Could Come Sooner Than You Think

Indeed, China has had significant bursts of economic reform in the past, most notably in the late 1990s during the premiership of Zhu Rongji. That era proved that bold reform is achievable when three conditions are present: a crisis of political credibility at home, vulnerability to an economic or financial crisis abroad, and a leadership savvy enough to recognize the need for change.

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Today, Beijing does face enormous obstacles, and the forces arrayed against reform are numerous and entrenched. But each of these three conditions is once again present in China, potentially boosting the prospects for real and enduring economic change.

A Crisis of Credibility

Consider the first condition: a crisis of domestic political legitimacy. In the early 1990s, Beijing faced one of its toughest tests of popular support as it attempted to recover from a series of political challenges to the Chinese Communist Party (CCP) during the tumultuous 1980s. At the time, Beijing was in the

throes of both a political crisis and a revenue crisis as dwindling tax receipts remitted by provinces and cities to the central government hollowed out the central government's coffers.

Throughout the 1980s, dizzying changes moved the country away from major elements of centralized planning toward greater reliance on market forces, including price liberalization. These changes ushered in a wave of inflationary pressures and rampant social discontent, which culminated in the protests of 1989.

In the aftermath of the political tumult, reforms were briefly shelved before being revived in 1992 as Beijing sought to restore economic momentum and win back popular support. By the late 1990s, a capable premier, Zhu, had begun to restructure China's weak and unwieldy state sector and to reform the banking system, notwithstanding the destabilizing effects of laying off millions of Chinese government workers.

Photo: World Bank/Steve Harris

This period is instructive because today's Chinese leadership—under pressure from rising expectations, social dislocation, and popular discontent—again finds itself trying to bridge a credibility gap with the Chinese public. And the new team, not least the new president, Xi Jinping, has publicly recognized that the stakes are high. With worsening social and economic inequality, abysmal food safety, corruption, and rising middle-class expectations, Chinese governance is being tested in unprecedented ways. And since merely delivering growth is no longer sufficient to assure the government's mandate, the leadership has good reason to look to reforms as a means of addressing social cleavages and environmental degradation.

External Economic Shocks

A second important factor that drove China's reforms in the 1990s involved the aftereffects of the Asian financial crisis of 1997-98, which exposed the inherent vulnerability of the Chinese economy to such shocks. Zhu and other Chinese leaders leveraged the moment of that crisis to move China toward its long-standing goal of membership in the World Trade Organization. They successfully pushed for a credible package of reforms that both prepared Chinese companies for global competition and opened the door to foreign capital inflows. Put simply, an external crisis enabled homegrown economic reformers to push forward serious economic and institutional changes.

That formative experience is especially pertinent today, as China continues to deal with ripples from the global economic crisis that began in 2008. Despite emerging from the crisis earlier and stronger than nearly any other major economy, China remains vulnerable in two ways: it can no longer rely on exports, and it lacks the flexible monetary and financial tools that could help it fight inflation and forestall the shock of another financial crisis.

Photo: World Bank/Yang Aijun

Beijing has weathered the most recent storm largely because it injected huge sums of cash into the economy—about $600 billion in stimulus and billions more in other bank lending, both of which helped to stave off a wholesale collapse in economic growth. But the effectiveness of these tools will diminish in the years ahead. The government cannot simply rely on stimulus after stimulus, and such a strategy would only further deepen imbalances in China's economy. In the five years since China achieved its peak GDP growth rate of 13 percent in 2007, its growth rate has dropped significantly and the leadership now targets a more balanced 7.5 percent.

Tough-Minded Leadership

Many of China's reforms in the 1990s would not have been possible without a few hard-nosed leaders who not only correctly assessed the country's economic ailments but also had the political will to take strong actions.

Zhu, for instance, was known to berate local officials for their mistakes and inefficiencies—and his confrontational style was supported by a number of his colleagues in Beijing. It is already apparent that Xi and the new premier, Li Keqiang, differ from their immediate predecessors in both style and tone. But more than that, their programs and speeches suggest that, at minimum, they have accurately diagnosed the ills that currently beset the Chinese economy. And on paper at least, they have prescribed many of the right solutions. In March, Li invoked "reforms" nearly two dozen times during his first press conference as premier.

But translating rhetoric into credible actions will be more difficult. China's new leaders have risen to the top only to inherit a growth model that is running out of steam, undermined by a combination of aging populations and weak consumption in developed countries. At the same time, many Chinese companies, especially in the state sector, remain uncompetitive or could face serious financial difficulties if

state subsidies, including for energy and land, are withdrawn.

It is important to consider, moreover, why the last group of Chinese leaders seemed to overlook structural maladies in the Chinese economy. Despite a recognition that, in former Chinese Premier Wen Jiabao's words, the economy was "unbalanced, uncoordinated, unstable, and unsustainable," previous leaders could rest easier in the knowledge that China could still mostly grow its way out of its immediate problems. In fact, growth was so stellar in the 2000s that the leadership cohort under former President Hu Jintao judged that it could probably afford to coast on the reform dividends of previous decades.

But although China's economy grew rapidly throughout the first decade of the twenty-first century—largely on the basis of investment and soaring exports—it did not grow much stronger in a fundamental sense. It remained relatively exposed to disruptions in global demand because domestic demand in China was too low, and it reflected new inequalities and imbalances. The costs of the capital-intensive and export-led growth model are now so obvious and startling that they can no longer be ignored or swept under the rug. For instance, recent estimates have put the environmental cost of China's growth at at least $230 billion, or about 3.5 percent of China's GDP in 2010.

So it is beyond doubt that Xi and Li understand, and even acknowledge, that reform is no longer a choice but a necessity. The scope, scale, and depth of those reforms, however, will ultimately depend on whether the new team shows some of the nerve and sense of timing that yielded the ambitious decisions of the 1990s.

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Devolution, Chinese-Style

What are the signposts of real economic reform? Several indicators will be important to watch over the next year and a half. One major indicator will be the degree to which Beijing reduces the state's role in the economy by devolving fiscal and budgetary authority to local officials. Steps in this direction would include passing off the power to approve infrastructure projects to local governments, cutting unnecessary administrative red tape, and prohibiting ad hoc administrative fees levied by local governments.

Some form of decentralization will also likely take place on the fiscal side. Many provinces have seen their fiscal coffers wither in the years since 1994, when a major tax overhaul redirected revenues toward the central government in

Beijing. Local governments now depend on transfers from the central government to pad their budgets. And when these transfers prove insufficient, as they usually do, they often turn to selling land to developers and relying on debt financing through shadowy lending channels to secure the revenue they need. Given that China lacks a well-developed municipal bond market or a strong independent local tax base, it is easy to see how a local fiscal system in disarray—one that provides incentives to sell land for housing development—has contributed to the country's overheating property market.

Another area ripe for reform is energy pricing. Throughout China's economic boom, Beijing has artificially suppressed energy prices because energy is a critical input in China's capital-intensive growth model. So with Beijing's persistent fear of spiraling inflation, the government has often intervened to ensure that the prices of electricity and coal, among other energy sources, remain stable. But the fact that energy is cheap means that Chinese industry has little incentive to improve efficiency. Instead, the country's companies have turned into energy guzzlers and decimators of the environment. Raising the price of energy to reflect its true cost would force Chinese businesses to improve efficiency and develop cleaner production methods.

A third area to watch is China's social welfare system, particularly health care and pensions. Beginning with reforms in 2009, China's broken health care system has been gradually stitched back together and will likely enter a new stage under the new government. Similarly, the fragmented and woefully inadequate pensions system will also need to move beyond its current state as a large-scale unfunded mandate. Both reforms are necessary if Beijing is to deal with an aging society and to support consumption by drawing down precautionary savings.

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Beijing Dreaming

In isolation, each of these reforms would be modest. Yet their cumulative effect could be enormous. It is worth noting, however, that expectations for economic reforms should be tempered by the reality of China's present economy—an $8.3 trillion behemoth that is more complex and mature than it was 15 years ago. In this sense, windfalls from today's reforms will likely be more limited in scope than when the country was starting from a lower base in the 1990s.

But that is what the new leadership confronts—a wide-ranging set of reform alternatives that include, but are not limited to, the options noted here. The constraints on reform in China have never been intellectual—there are plenty of good economists in the

country pushing a wide array of creative ideas. The principal obstacles remain political. The lesson of the 1990s is that it takes the right mix of domestic and external challenges, combined with a healthy dose of bold leadership, to induce significant reforms.

But those conditions are again present today. And recent statements suggest that a longer-term reform agenda is likely in the works and could be unveiled during the CCP's third plenum this fall. (Capital market reforms, such as an expanded use of corporate and government bonds and a further relaxation of restrictions on foreign institutional investors, are thought to be probable.) If Chinese leaders do choose the third plenum as the place to announce new reforms, it will be because it is pregnant with political symbolism: it was at another third plenum, in 1978, that Deng Xiaoping, the architect of China's market reforms, won consensus around the vision that set China on its course to becoming the world's second-largest economy.

It would be impossible for any Chinese economic reform program to be completed expeditiously and without resistance. Reform, by definition, will rearrange the playing field for powerful political and economic interests. But if the new team is serious about revitalizing China's economy and realizing its much-touted "Chinese dream," then deeper economic reforms are necessary. Beijing would do well to heed the words of Li, its new premier: "It's useless screaming about reform until you're hoarse. Let's just do something about it."

After the Plenum: Why China Must Reshape the State

In early November, as Beijing braced for the Communist Party's Third Plenum, the high-level conference that would decide major policies for the next decade, President Xi Jinping appeared to deliberately raise expectations for major economic reforms. He spoke of a "comprehensive" reform plan and invoked Deng Xiaoping, the man who changed history by overhauling China's economy and politics at an earlier Third Plenum, in 1978.

Yet no sooner had the plenum closed and the party released its initial communiqué than observers dismissed the meeting as a bust. Markets slumped. Hong Kong's Hang Seng Index dropped 1.9 percent, to its lowest level in ten weeks. The Shanghai Composite lost 1.8 percent. Many commentators argued that China's leaders, faced with their first big test, were disinclined—or else too timid—to undertake the sweeping economic reforms that Xi had promised.

But then the verdict abruptly shifted with the release of a follow-up 60-point decision document, which presented a sweeping economic reform agenda that included new commitments to financial liberalization, the repair of China's social safety net, new protections for property rights, and greater reliance on market forces. Across Asia, the markets shot upward.

Several factors explain this quick swing from pessimism to exuberance, not least of which is a volatile combination of high expectations for China as the world's second-largest economy and deep cynicism about the Chinese leadership's intentions and political will to overcome vested interests that oppose reform. Many look to Beijing to change its investment-led growth model to one based on consumption and innovation. And many will continue, therefore, to see what they want to see in the plenum's reform agenda—both its promises and shortcomings.

The plenum has reinvigorated a reform process that will, in time, make the Chinese economy more resilient, dynamic, and sustainable.

But it is vital to assess the plenum's commitment to reform against the realities of China's political economy and the Chinese government's own goals. And, on that score, the plenum has reinvigorated a reform process that will, in time, make the Chinese economy more resilient, dynamic, and sustainable.

To Market

A month removed, it is possible to be more reflective about the plenum, what it did, and what it failed to achieve.

The meeting's principal conceptual contribution was to replace the word "basic" with "decisive" in the

60-point "Decision on Major Issues Concerning Comprehensively Deepening Reforms" to describe the market's role in allocating resources. With that change, it is now clear that the Chinese government is committed to pursuing and executing market-based reforms, much as we predicted in *Foreign Affairs* last spring. From Beijing's perspective, this is an intellectual breakthrough because it means that Chinese leaders are prepared to allow the market to have a greater role in parts of the economy that have, until now, been mostly reserved for the state.

One example is the allocation of capital, which has been concentrated in government-backed banks or else in informal lending channels. The plenum committed to boost the formal role of private capital.

Still, although this breakthrough is substantial, it would be a mistake to think that it is conclusive: to make the market decisive, the state must also retreat. That is why the question of the role of the state will define much of the reform challenge ahead. China's premier, Li Keqiang, has declared war on powerful "vested interests" that oppose market reforms. But the biggest vested interest in the Chinese economy is, in fact, the state itself.

So Beijing must change the state's relationship not only to the economy but also to Chinese society and individual citizens. Simply put, the state must transition from an "administrative" state to a "regulatory" one—in other words, it must become more of an umpire among contending interests than an active participant in an economy that referees itself.

None of that will be easy to do. Even after 35 years of economic reforms, ideologues remain. They instinctively distrust market forces and still prefer the government to manipulate and control the market. The plenum's outcome suggests that the state must surrender such roles if many of the reforms are to take hold.

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Take prices—a fundamental market signal of the relationship between supply and demand. In China, three important prices have been controlled by the state or have been subject to the frequent interventions of Chinese bureaucrats: the exchange rate (the price of the Chinese yuan relative to other currencies); the interest rate (in simplest terms, the price of money); and energy and resource prices (input prices).

To reduce an expensive subsidy to export industries and encourage domestic consumption, China's currency was already appreciating before the plenum, and the eventual shift to a market-determined exchange rate seems almost certain over time. But the

other two sets of prices—interest rates and energy prices—also appear poised to be further liberalized.

First, China has already liberalized lending interest rates, but it is likely to eventually liberalize deposit rates too. The Chinese central bank has outlined various steps, including testing the policies on an experimental basis in the newly established Shanghai Free Trade Zone and establishing deposit insurance, that should lead to market-based rates over the next several years.

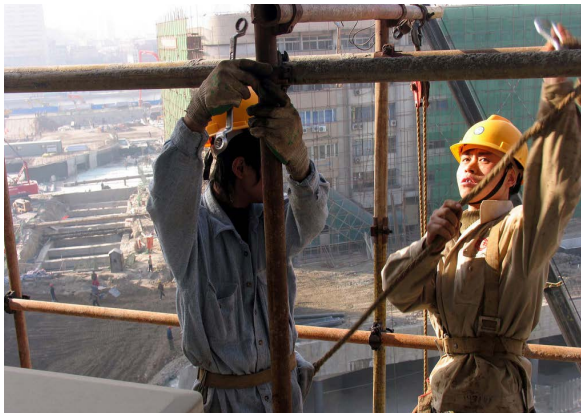

Photo: World Bank/Yang Aijun

Second, over the last decade or so, China has haphazardly liberalized the prices of some inputs but not others. In many cases, that has created complicated and distorted prices. For instance, although China imports crude oil at global market prices, the rate at the pump is controlled by the central government to protect consumers from inflation. This policy has led to regular hoarding of gasoline before anticipated price hikes and gripes from the oil industry about losses on their upstream investments. But during the recent plenum, China pledged to liberalize the price of commodities and scarce resources that have previously been subsidized, including oil, natural gas, and, over time, perhaps even water.

Subjecting these prices to market discipline will encourage more competition, allow banks to operate more like commercial ventures, and incentivize energy-intensive producers to become more efficient and invest based on a truer sense of costs. Market-based pricing will be a powerful tool for the government and companies to rationally and efficiently allocate resources and manage runaway resource consumption. To do so, however, the Chinese state must also be prepared to cede a long-standing pillar of its authority, reduce price controls, and perhaps tolerate a higher level of inflation.

Social Contract

Millions of Chinese once relied on an explicit social contract with Beijing. For most of its contemporary history, the state provided virtually all aspects of job security, social security, and retirement security, usually delegated through state-owned enterprises (SOEs) and other work units (*danwei*). That changed in the 1990s when SOEs, facing a "reform or die" moment, were forced to dramatically alter their functions. They became more commercially oriented and, in the process, shed many of their welfare obligations.

But since then, Beijing has largely failed to replace the old system with a new one of comparable quality and scope. Local governments, seduced by the lure of investment-led growth, spent liberally on infrastructure, housing, and other fixed assets rather than on welfare and retirement services. In some cases, local politicians shifted resources from social welfare to lucrative ventures such as real estate. One Politburo member, Chen Liangyu, was even indicted for pilfering some $4.8 billion from Shanghai's social security funds to line the pockets of property developers.

Photo: Flickr/Mark Weston

The plenum unambiguously articulated the need to repair China's social safety net, in part through fiscal transfers that will allow the central government to boost public spending on health care and pensions. It also encouraged the private sector to play a larger role in providing these services, particularly as an aging Chinese society demands more benefits. In an ironic twist, SOEs will likely be forced to partially resume their previous role as a source of social services funding. The dividends that they pay to Beijing will be raised two or three times to 30 percent by 2020, with the additional funds going to social welfare.

But to meet the public's needs and rising expectations, the state cannot simply rearrange resources and rebuild the social contract. It must also deal with the questions of property rights and mobility. The plenum decision began to address these by giving citizens, especially rural Chinese, more property rights. Although the state nominally "owns" all land, Chinese citizens living in cities are allowed to buy and sell property, and they have a mortgage market to help them do so. But rural farmers have virtually no right to sell, transfer, or develop their own land. The plenum pledged, albeit without a timetable, to permit rural land to be sold, rented, or leased with "equal rights" and "equal prices" to state-owned land. Allowing farmers to use land as collateral should soon follow. And that, in turn, should incentivize rural Chinese to move into cities and take jobs in more productive sectors.

The logical next step would be to reduce, and eventually remove, controls on mobility—the so-called *hukou* system that denies millions of Chinese equal access to social welfare benefits on grounds of "illegal" migration to the cities. The policy, enacted in a previous era to prevent a massive influx into cities, no longer makes much sense. China is

now a majority urban country and the legions of migrants who intend to remain in the cities will not leave simply because the government denies them equal rights. There is a hint of change that the *hukou* policy may now be scrapped in townships and smaller cities—but it will come neither quickly nor easily.

State of Being

Ultimately, China will need to reorder the state's basic functions relative to the market, the social contract, and the citizen. But Beijing must also look to remake the state itself so that it is more capable of governance that will allow the market to work. That means the state must become more of an arbiter-like umpire than a pervasive and self-regulating participant in the economy.

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Liberalizing prices is one step in the right direction because it will weaken bureaucracies whose current mandate permits them to use price controls to interfere with the market. Another step would be to ease market entry for private firms, which often face high administrative hurdles from local authorities. Already, the central government has taken modest steps with reforms that cut down on red tape and streamline project approvals at the local level. China has no dearth of rules and regulations, but there are few checks or balances on the state. Beijing could get back to basics by strengthening regulatory institutions and increasing enforcement capacity.

Yet surely many will wonder how the state can be remade if SOEs remain so dominant in the economy. The plenum's decision revealed no intention to either downsize or privatize the most important state-owned firms, but such expectations were unrealistic in the first place. The fact is that large-scale privatization is off the table for now.

Still, Beijing could help to discipline SOEs by exposing them to robust competition. If the sectors that they now dominate were opened to private firms and foreign entrants, SOEs would become less sheltered entities. The plenum document alluded to this, but the test is likely to come in trade and investment negotiations. Foreign competitors will insist that Beijing open more sectors to fair and equal competition, and this would ultimately benefit Chinese firms too. If SOEs cannot compete and survive, then the state would need to be prepared to let some of them fail, much as the Chinese government ostensibly tolerated in the 1990s.

Competition is an essential ingredient of well-functioning markets that shapes the behavior of a firm, whether it is public or private. Norway's Statoil is a state-owned firm that behaves like any private firm and has adopted global

best practices. By contrast, the Chinese telecom giant Huawei is a nominally private firm that functions more like a state-backed national champion, often receiving state support in various guises. Even without privatization, then, Chinese SOEs could become more disciplined if they were exposed to greater domestic and foreign competition.

It is no small thing to restructure a $9 trillion economy, in which financial, labor, and industrial reforms are now inextricably interconnected. If reforms are to succeed, China needs not just to expand the market but also to refashion the state, even if a large state sector remains a fact of life. This is, ultimately, more of a political question than an economic one, and one that cannot be resolved overnight. So it is no surprise that Beijing gave itself until 2020—halfway through Xi's second term, when he is expected to be joined by five new colleagues on the seven-member Standing Committee, a wholesale turnover—to implement some of the toughest reforms. That will buy the Chinese leadership and its economy some breathing room as the country attempts such a massive rebalancing.

Many have bet long on Chinese growth over the last decade, believing that Beijing would continue to show a surprising capacity to adapt. The ambitious economic reform agenda that emerged from the Third Plenum suggests that their instinct was, on balance, right. Even amid a wave of bearish sentiment in recent years, it would be worthwhile to again bet long on reforms over the next decade.

Federalism, Chinese-Style

More than a year into Chinese President Xi Jinping's tenure, Beijing's economic mantra has remained remarkably consistent and clear: China's growth model is broken and needs to change.

The Chinese Communist Party enshrined that pledge in its economic reform agenda at last year's Third Plenum, and then reaffirmed it in March at the annual session of China's legislature, the National People's Congress. But such clarity of purpose cannot obscure the fact that the actual execution of economic reforms will not succeed unless the Chinese state reshapes itself in far-reaching ways.

For one thing, the scope of state power in China needs to be rolled back. The plenum's most important policy decision was to announce that the market would now play a "decisive" role in allocating resources. If that is to be true, then many of the functions that the state currently performs, such as setting prices, must instead be left to the market.

Yet even as China needs to curtail certain state powers, it still requires a resilient and effective state—to enforce rules and standards, provide public goods, and perform a vast array of administrative functions. And it needs those tasks to be handled at the right administrative level. Beijing too often does things that would be better left to provinces and municipalities. Local governments, for their part, frequently take on responsibilities that Beijing could handle more effectively. This has led to several significant problems: unfunded mandates, confusion about who is in charge, and policy paralysis.

Put bluntly, China needs a new "federalism"—a realignment of central and local government power—that can adapt to the conditions of a rapidly changing economy. And that is precisely what is under debate in China today.

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State of Change

What will this emerging Chinese federalism look like? It most certainly will not turn provinces and cities into autonomous actors vested with the sort of independent decision-making power that states have in the US and Indian systems. Chinese-style federalism will instead decentralize some powers and recentralize others, rebalancing governing responsibilities in a more rational way.

China is no stranger to the challenges of federalism. But its leaders have long

preferred to prohibit a true devolution of authority for fear of empowering local warlords or jeopardizing the country's hard-won unity. Indeed, the searing historical experiences of the country's dynastic and modern leaders continue to shape the Chinese view of governance in the contemporary era. Especially in the nineteenth and twentieth centuries, the Chinese state repeatedly fractured into autonomous fiefdoms or powerful regional viceroyalties, only to be reunified under new, but sometimes weak, central authorities. As a result, both the Nationalists and the Communists tended to prefer a strong centralized state that circumscribed the authority of the provinces.

Photo: World Bank/Steve Harris

Deng Xiaoping's early reforms in the late 1980s included several experiments with economic decentralization. One example of this approach was the creation of special economic zones in coastal cities such as Shenzhen, which were allowed to incubate market reforms and experiment with private enterprise. Once these experiments proved workable, the top leadership allowed them to be scaled up and replicated nationally.

The provinces, in turn, competed fiercely based on the logic of China's socialist political economy. While pledging fealty to the party's policy mandates, provincial authorities poured money into local efforts to attract businesses, spur investment, and sustain growth, sometimes at the expense of national standards or consistency across provinces and cities. The central government maintained control and laid down rules and guidelines. But when Beijing pursued competing priorities—promoting environmental sustainability at the expense of growth, for example—localities frequently ignored these mandates.

That kind of haphazard decentralization now stands in the way of Beijing's new reform priorities. The lack of alignment between central and local goals has become endemic and unsustainable. Ultimately, Xi's ambitious reform agenda requires an overhaul of how Beijing and the provinces share costs, finance projects, raise funds, regulate the economy, and incentivize local and municipal governments to carry out the reforms.

Take, for example, the leadership's sweeping commitment to urbanization, through which it aims to boost productivity, personal incomes, and domestic consumption. Beijing has pledged to move some 300 million

people into cities over the next two decades. And although that reform looks impressive on paper, it requires increased spending on public goods, such as health care, with much of the cost passed back onto local governments that lack broad authority to raise revenue through taxes or bonds.

Tax and Spend

For these reasons, Xi's reform efforts may yet die in the provinces if Beijing does not rejigger Chinese federalism to reflect the practical demands of local governance. Specifically, three sets of powers—fiscal power, administrative-approval power, and enforcement power—need to be recalibrated in ways that rebalance authority among different levels of government to increase the chances that market reforms succeed and endure.

China needs to overhaul a fiscal system that is beset by inefficiencies and contradictions.

China needs to overhaul a fiscal system that is beset by inefficiencies and contradictions. At the bottom, localities theoretically adhere to Beijing's mandates to provide services such as health care, but they often lack sufficient revenue to do so. At the top, meanwhile, Beijing worries that dispensing more tax and bond-raising power will fuel corruption and lead to the accumulation of more local debt, which is already pressuring China's fiscal system to the tune of some 18 trillion yuan ($3 trillion).

China last overhauled its tax system in 1994, when Beijing moved to claw back a larger share of revenue and strengthen the central government. During the 1980s, the central government's revenue had drastically declined, in large part because localities were overspending without sending enough tax revenue back to Beijing. In 1994, the central government introduced a value-added tax (VAT), eliminated several other local taxes, and essentially centralized the entire tax collection process.

Over the next two decades, Beijing fattened its coffers—the central government netted about $1 trillion in 2013, for example—but at the expense of local budgets. And this happened at a time of increasing public demand for more government services and better local infrastructure. As a result, provincial governments came to rely on other sources of income—namely, land seizures and sales to property developers as well as shadowy local financing vehicles and other off-the-books revenue sources.

Centralizing the fiscal system seemed to make sense in 1994, but the negative consequences are now apparent: as local governments have come to rely on alternative revenue schemes, China has seen a wasteful spree of infrastructure-intensive growth and housing bubbles,

which has further contributed to the rapid accumulation of destabilizing local debt.

Such spending pressures will not let up anytime soon. Indeed, they will probably grow worse as China's urbanization and reform efforts progress. Meeting Xi's aggressive urbanization goals, for example, will require more spending on social services for millions of new city dwellers, in addition to huge investments in new infrastructure. Local governments will need more revenue, and will likely continue to exchange land for funds.

Photo: World Bank/Curt Carnemark

For its larger reform project to succeed, then, Beijing must adapt its fiscal policies. This will require a further centralization of revenue authority, even as more sources of local revenue are created. Beijing will ramp up existing taxes or create new taxes that it collects directly, only to redistribute the funds back to the local level. That way, Beijing can better control local-level spending—by allocating funds to local governments on the condition that they will be spent on social services rather than apartment complexes and empty shopping malls.

And reform should devolve certain other authorities to help the system strike a proper balance between levels of government. For instance, Beijing will almost certainly implement its long-delayed effort to expand property taxes, thus assuring more local revenue tied directly to home ownership. Imposing a local property tax will also increase transparency by disclosing the assets of those who are taxed. Other additional revenue streams could come in the form of new local tax categories, since many local taxes are currently being wiped out by the expansion of the national VAT.

Decision Point

Making the market "decisive" will require that the state retreat from some economic activities altogether. And one way to do that is to change the state's function from a highly interventionist micromanager to an umpire-like regulator. Beijing has already begun this process, through Premier Li Keqiang's continuing effort to eliminate hundreds of central administrative approvals. Cutting through China's mind-boggling maze of red tape comports with Li's oft-repeated mantra to "let the market do what it does best."

Administrative federalism needs to achieve two principal goals: first, to grant localities more authority to approve investment projects and

licenses for private businesses that make sense for the local economy; and second, to demonstrate at least some effort to reduce central bureaucratic meddling in local projects.

Fundamentally, Beijing's new emphasis on administrative federalism reflects a recognition that the central government needs to become more of a macro regulator than an active meddler in how business and investment are conducted, especially in the private sector, which is now the principal source of job creation in China.

A proper balance among levels of government is also required for Beijing to achieve its other reform goals. Xi has pledged, for example, to balance breakneck economic growth with its social and environmental costs. But although growth requires decentralization to free the market from the shackles of uppity bureaucrats in Beijing, local governments frequently ignore environmental regulations and standards, yielding severe pollution and toxic conditions. To ensure that localities do not simply flout air, water, and food safety standards, Beijing needs more consistent and predictable enforcement.

A proper balance among levels of government is also required for Beijing to achieve its other reform goals.

One way to do all of this would be to further reform the system used to evaluate and promote local politicians, which is currently regulated by the central government. Beijing is attempting to realign incentives by holding provincial and local cadres accountable for not just growth but also social services and environmental protection, as part of their job evaluations.

Another potential solution under debate is to modestly empower China's court system to act as a quasi-independent enforcer of certain regulations and policies. This would surely be difficult in a system controlled by a single party that lacks independent judicial checks. It would require eliminating all political interference and corruption in local courts, and creating a legion of well-trained legal professionals. But legal checks would be a more sustainable means of shaping incentives than politicized anti-corruption campaigns that scare localities and officials into compliance.

An Age of Reform

The opening line of the classic Chinese novel *Romance of the Three Kingdoms* offers a useful explanation of why China's rulers have, for centuries, feared true federalism: "The Empire, long divided, must unite; long united, must divide." Throughout the modern era, especially against the backdrop of debilitating warlordism in the 1920s, the country's leaders have feared that a decentralization of authority would lead to competing power centers, which

would threaten the integrity of the Chinese state.

But a twenty-first-century state needs checks, balances, and a rational division of powers. And a twenty-first-century economy, especially one with a more "decisive" role for the market, requires the division of authority among multiple levels of government.

A rational division of the state need not mean a fragmentation of the state. Beijing has clearly articulated its political commitment to economic reforms. But it now needs to show the same political audacity to refigure its own role, and that of the provinces it governs, in meaningfully executing those reforms.

About The Paulson Institute

The Paulson Institute, an independent center located at the University of Chicago, is a non-partisan institution that promotes sustainable economic growth and a cleaner environment around the world. Established in 2011 by Henry M. Paulson, Jr., former US Secretary of the Treasury and chairman and chief executive of Goldman Sachs, the Institute is committed to the principle that today's most pressing economic and environmental challenges can be solved only if leading countries work in complementary ways.

For this reason, the Institute's initial focus is the United States and China—the world's largest economies, energy consumers, and carbon emitters. Major economic and environmental challenges can be dealt with more efficiently and effectively if the United States and China work in tandem.

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Specifically, The Paulson Institute fosters international engagement to achieve three objectives:

- To increase economic activity—including Chinese investment in the United States—that leads to the creation of jobs.
- To support urban growth, including the promotion of better environmental policies.
- To encourage responsible executive leadership and best business practices on issues of international concern.

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