

China's Challenges

Observations from 25 Years
of
Teaching About the Economy

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Key Issues

- Agriculture – Urban Linkages
 - The Burden of Incomplete Land Reform
- Financial Deepening
 - The Burden of Financial Repression
- Public Goods Provision
 - Who funds, who provides: vertical structure of public finance
- Savings-Investment Balances
 - High private and business savings

Agriculture:

Land Grabs aren't the issue

- underlying issue is unfavorable elasticities
 - output per unit of land is much higher
 - offset by higher inputs for
 - commercial seed
 - chemical fertilizer, herbicides, and pesticides
 - water [though that is underprice in much of China]
 - tools (including tillers and tractors and trucking services)
 - labor inputs to land are much lower
 - so physical output per hour worked has not risen
 - net of inputs, the story is worse

agriculture and land (cont)

- so what has happened to prices?
 - income elasticities and price elasticities of agriculture are unfavorable
 - despite income growth, prices don't make working small plots of land profitable
 - hence the labor outflow from the agrarian sector
 - under the current landholding farmers cannot earn a competitive income, and the situation will only worsen

agriculture and land (cont)

- land grabs are unethical but
 - only affects a minority of farmers in certain (unfortunate) geographies that make land ripe for harvesting as a local income source.
- lack of clean ownership rights
 - affects **ALL** farmers
- 1950 land to the tiller policy
 - plus additional redistribution
 - previous system of muddy rights to land
 - complicated layers of title and tax obligations
 - current situation similar: land is not “free & clear”

agriculture and land (cont)

- titular control is with local government
 - and venality is well known
 - 10s of thousands of officially counted protests each year over reassignment from farmers to developers
 - without, of course, much compensation
 - no studies of how many transfers occur with adequate compensation. my sense is that in the 1980s this process was

agriculture and land (cont)

- **however**
 - in practice about 20% of farmers rent in land
 - no other developing country has anything like that!
 - the normal tenure issues exist
 - those renting land invest less in maintenance
 - offset by less expensive fertilizer and other inputs
- **but**
 - subsidies now widespread and rising
 - rural taxation has been totally abolished
 - almost 80% of farmers receive cash subsidies
 - ≈ US\$35 per acre so while small at household level, not trivial
 - hence from a fiscal perspective land issues loom large

Fiscal Structure

- tax revenues flow to the center
 - urban land grabs the key source of urban revenue
 - rural areas rely increasingly on transfers
 - how allocate transfers?
- how bolster local revenue sources?
 - trial balloons for urban real estate taxation
- meanwhile debt financing
 - not transparent
 - with presumption that there are lots of low-payoff projects
 - except perhaps in that those involved pay off each other

Financial Deepening

- in Japan two sources of finance
 - banks started by landed elite in late 1800s
 - stock and bond markets followed
 - legitimization of informal financial institutions
 - village “savings clubs” and rural moneylenders
 - ➔ Mutual Savings Banks, Credit Associations
- how to support informal
 - and gradually institutionalize
- ***issue is poorly studied***

Financial Repression

- low nominal deposit interest rates
 - often below inflation
 - common to developing countries
 - distortions well-known
- in a life-cycle model depresses consumption
 - raises savings as need to set aside more for retirement
- passed on to borrowers
 - but SOEs and city governments don't need subsidies!!
 - capital in China should be expensive, not cheap
 - distortions amplified by slow pace of financial deepening

Micro-macro Balances

- High personal savings reflect
 - (i) demographics
 - (ii) financial repression / shallow financial sector
 - (iii) underprovision of public goods
 - lack of social insurance: healthcare, pensions
 - private markets don't exist or (as in US) don't work well
 - Chinese who grew up in the 1960s were taxed for this while young
 - but receive nothing now: morally noxious!!

Savings-Investment Balances

- at present high household savings & high corporate retained earnings
 - SOEs don't pay dividends to the State
 - lots of wasteful activities and “wealth transfers”
- open economy balance
 - $(S - I) + (T - G) \equiv (X - M)$
 - government already spending a lot, but small deficit
 - so translates into trade surplus / intl capital flows
 - from which Chinese citizens do not benefit

S-I balances

- Inevitable growth slowdown
 - Investment “I” will fall
 - but demographics move slowly
 - “S” will remain high
 - the Paradox of Thrift
 - trade surpluses must increase
 - not feasible since China is large in the global economy
 - hence government as borrower of last resort
 - to soak up private savings
 - Japan as example of chronic excess savings

Scenario for An Old China

- Retirement at the macro level
 - must be pay as you go
 - current consumption (incl healthcare) of retirees must come from current production
- tensions
 - private systems can fail at that
 - when baby boomers retire they sell assets
 - but who's left to buy in an aging population?
 - in which case diligent savings leads to penury in old age
 - public tax-and-transfer inevitable
 - in the face of the reversal of the second demographic dividend

- when private savings are high, no underlying tension
 - only whether institutions will make that transfer
 - for those lucky enough to have assets, sell to savers
 - for others the govt must borrow to finance pensions & health
- when private savings fall
 - consumption of those in the workforce crowds out consumption of retirees
 - not politically sustainable, not ethically acceptable
 - so tax (to depress consumption) and transfer (to retirees)
- Chinese government as insurance company
 - over time shift from the provision of public goods
 - to the provision of old age security