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SEEKING TRUTH

Seeking truth is what scientific inquiries are all about. I am very grateful for this opportunity to share my views in a seminar headlined *Provision of basic public services in China*.

Now, seeking truth is a risky business. You may easily end up stating things many people rather saw remained unstated. Sticking to my topic, i.e. seeking truth, I shall have to share with you my best assessment of current issues facing the Chinese model for economic and social development at the present junction.

In a recent paper professor Barry Naughton at University of California, San Diego¹ argues that China has the capability to make the transition to lower growth rate in the context of a wealthier and better-off society “.... if policy-makers muster the will and determination”. But, alas, this is the issue. What does it take for policy-makers to muster will and determination? How to handle those who have the ability and power to make the transition grinding to a halt?

Economics is not physics

On its own, economics is a simple science. Conclusions are arrived at through deductions. Thus, the conclusions are embedded in the assumptions. And the assumptions are to a great extent dictated by the history of the field itself. Problems and challenges arrive when testable hypotheses, derived from the theory, are confronted with data.

When stories economists tell are compared to those told by other social scientists, challenges abound. Why? Because concepts differ, a consequence being that different fields of the social sciences have different understanding of what actually goes on in the real world.

Economics is not physics, professor Friedrich Hayek reminded us about in his Nobel lecture of 1974. ”I prefer true but imperfect knowledge, even if it leaves much undetermined and unpredictable, to a pretence of exact knowledge that is likely to be false.”²

¹ “China’s Economy: Complacency, Crisis, and the Challenge of Reform”, paper presented at the conference “China’s Rise and Its Fifth Generation Leadership. Does leadership matter?”, Norwegian Institute for Defence Studies, Oslo, May 23-24, 2013.

² Hayek, F. A. (1974), “The Pretence of Knowledge”, Nobel Price Lecture, 11 December, 1974.

Social sciences are not like physics, with irrefutable laws. Social sciences deal with human beings. Their behavior is not conducive to rules or laws waiting to be revealed. This calls for a good deal of humility

Social scientists, I guess, do their job best when they tell their stories as well as they can, acknowledging that there is more than one game in town. This world is a complicated place, and the behavior of human beings is hard to understand. And even more difficult to predict. This being so, different people, based upon different notions and different ways of looking upon things, can all contribute to our understanding. This seminar is an example of such an interdisciplinary approach to China, and to the challenges facing the Middle Kingdom.

More on the economic challenges facing China

Looking at China today and the economic challenges ahead, the essence of the problem may be described as follows: How to move from an investment driven model of growth to one in which private consumption is increasing its share of total output?

At the present junction, most China observers seem to be in broad agreement of what needs to be done. The problem is implementation. The topic of the present seminar – *Provision of basic public services in China* – goes right to the centre of the matter. With the state to a greater extent providing for health, education and pension, and the Chinese people believing that to be so, a greater share of income will be consumed.

However, in order to finance more basic public services in China, the government take shall have to increase. That means higher taxes. For aggregate consumption to grow, those with a low marginal propensity to consume should be taxed more heavily and those with a high one, more leniently. This implies a redistribution of purchasing power from the rich to the poor.

Exploitation of the many by the few

Short of a robust political system that can make changes that are detrimental to the powerful, the role of the top echelons in CCP becomes more important than what is the case in a democracy. Or to apply the concepts of Acemoglu and Robinson in *Why Nations Fail*, China, being a country with extractive institutions, to change that into a society of a more inclusive nature, is the task ahead. To successfully solve this task one needs bold leaders that are uncorrupt, clairvoyant, intelligent and with some charisma. Deng Xiaoping and also Zhu Rongji fit that bill and perhaps Jiang Zemin to some extent too. The new leaders, Xi Jinping and Li Keqiang, are uncorrupt and bold. They seem to have what it takes to transform China into a more inclusive society.

The famous Chinese economist Wu Jinglian, in explaining why reforms have come to a halt, argued that "... as life got comfortable, reforms stopped". Comfortable for whom?

Yes – vey much so for those at the top. But as inequality keeps increasing; the environment keeps deteriorating; and urbanization keeps placing an increasingly heavy burden on migrant workers, life is not getting more comfortable for the majority of the Chinese. Not in relative terms, at least.³

Yes, all the boats are being lifted by higher water. But some much more than others. What expectations are thus created? Albert Hirschman has another analogy than the tide lifting the boats that may be more appropriate, namely automobiles stalled on the freeway.⁴ After a while the cars in the lane next to you start moving, making them happy, and also you, in the expectation that cars in your lane soon will start moving. As time goes by and you remain stalled, optimism gives way to pessimism and anger. Is this a more relevant picture of China today?

Reform with losers

Towards the end of the 1990s Prime Minister Zhu Rongji imposed reform with losers, by slimming down state owned enterprises, in a process where more than 40 million Chinese lost their jobs. The prime minister, however, sweetened the pill by opening up the market for real estate. You lost your job, but got your flat, almost for free.

Can Xi Jinping and Li Keqiang forge the necessary coalition of likeminded leaders seeing through necessary economic reforms? Or are embedded interests way to strong?

By way of analyzing the situation it seems to me that three classes have come together to usurp the rest of the Chinese:

- People in the CCP that wield political and military power. Remember the PLA is accountable to Xi in his capacity of General Secretary of the Party, not in his capacity as President of PRC.
- People in the business community that are responsible for the Chinese “Wirtschaftswunder”. They have the money. When Jiang allowed them, and most likely wanted them, to join the CCP through his “Three Represents”, I came to think of the American slogan, “If you can’t beat them, join them”, but in a slightly rewritten fashion: “If you need them, let them join you”, which is exactly what Jiang did, and perhaps thought.
- Intellectuals, who these days are having easier access to funds than before. “Even the universities have plenty of money”, Naughton notes.⁵

³ Wu Jinglian (born 1930) complains that business tycoons and corrupt officials have hijacked the economy and manipulated it for their own ends, a system he calls crony capitalism, see http://www.nytimes.com/2009/09/27/business/global/27spy.html?pagewanted=all&_r=0

⁴ Hirschman, A. (1958), *The Strategy of Economic Development*, Yale Paperback.

⁵ Page 4 in his paper, see footnote 1.

By having power, money and intellectual capacities joining forces, at the expense of the rest, a society in which those three classes exploit the rest emerges, i.e. an increasingly uneven society.

Robustness more important than stability

Not only that, since those in power feel insecure, they do whatever it takes to maintain *stability*. However, focusing too much on stability comes at the price of reduced *robustness*. Allow steam to be let out, i.e. allow stability to be shaken, and the system becomes more robust.⁶ Democracy, for all its faults and shortcomings, can perhaps best be viewed as a system that is robust, exactly for the reason that stability sometimes is shaken. That goes for market economies too; their robustness is derived from an orderly way of bankruptcies, which destabilize the economy for a short time. By creating entities that are too big to fail, the rich countries of the world are becoming much less robust. Schumpeter's process of "creative destruction" is not allowed to run its course. This comes at the peril of the system's viability in the long run.

In China also the process of creative destruction is artificially kept in check through the system of state-owned enterprises (SOEs) and state-owned banks (SOBs). They are too powerful and too interconnected to be allowed to fail.

A repressed financial system where SOBs pay a small or negative real rate of interest on deposits and channel the proceeds to SOEs at below market-clearing rates of interest, contributes to a transfer of wealth from the many to the few. A generous tax regime for SOEs, by adding to their profitability, does likewise. On top of it all, natural resource companies in China are charged a very low royalty.

The power vested in the SOEs is clearly seen in them paying next to nothing in dividend. As of late there has been some progress here.

As there are no alternatives in a one-party system, corruption is likely to thrive. The good news on corruption is that it makes things happen – it speeds up the decision making process. A China with a modest level of corruption would be growing less rapidly, but perhaps be more harmonious. To be successful in business you increasingly need political connections.

We will know more in the fall

In October or November the three hundred people plus of the Central Committee get together. At that junction Xi and Li should have a program for change approved and then put into practice. Is the system conducive to change? Will the necessary institutional

⁶ What kind of marriage do you have? A stable one? Or a robust one? The latter is much to be desired.

changes take place, i.e. will the ruling elites allow for more inclusive political and economic institutions?⁷

“They pretend to pay us, and we pretend to work”, was a saying in the USSR. Unless the third plenum in the fall is successful, along the lines sketched above, people in China may soon say: “They pretend to make changes, and we pretend to approve”.

In America one use to say that money is power. In China, you may say that power is money. That follows from a one-party system.

“Why would those who benefit so abundantly from the system really act to change it?” Naughton asks, adding that “the biggest interest, then, is that interest represented by the Communist Party itself”.⁸

The case for reform is a strong one. Will the argument that business as usual is more risky than reform carry the day? And is the present political system robust enough to see through necessary economic and social reforms?

The economics of it is simple

In spite of what I said at the very beginning of this paper, the economics of the present challenge is fairly simple. The “two ratios” need to increase:

- Total wage bill relative to GDP must go up
- Private consumption relative to the total wage bill must increase

This necessitates a redistribution of income. More to those who are exploited from those who do the exploitation. Private consumption would shoot up the very day people believe that the state takes care of health, pension and education to a significant greater extent than today. Saving for a rainy day will then taper off.

But to do so, the state needs more income. One avenue is to have state owned enterprises pay proper dividend. But how to make them do that? The fact that SOEs themselves to a great extent determine payout to the owners, attests to the power of business over politics when it comes to business.

A final comment

Professor Robert Solow – also a Nobel laureate – brings attention to the need for “keen observation and shrewd generalization” in economics, adding “there is a lot to be said in

⁷ In Financial Times 20 May 2013 we read: “Premier Li Keqiang recently played down the expectations that there is much the government could or should do, saying that China must rely more on ‘market mechanisms’.”

⁸ Remember Keynes though: “It is ideas, not vested interests, which are dangerous for good and evil.”

favor of staring at the piece of reality you are studying and asking, just what is going on here?”⁹ Economists often do not heed this advice, at the peril of not getting the facts right.

“Seeking truth from facts”, was a saying that Deng Xiaoping frequently employed. I have here elaborated on the first part – seeking truth. The latter part – getting the facts right – is no less demanding.

⁹ Robert Solow (2005), “How did economics get that way & what way did it get?” in *Dædalus*, Fall 2005.