China’s Challenges
Observations from 25 Years of Teaching About the Economy

Michael Smitka
Professor of Economics
Washington and Lee University
April 2014

© Michael Smitka 2013
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
  – \((S - I) + (T - G) = (X - M)\)
    • 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