Reviving China's Growth: A Roadmap for Reform。

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After a peaceful power transition in the 18th Party Congress, the new leadership in China is again under the limelight. The world is watching how it tackles the many challenges facing the nation: rising inequality， worsening pollution, rampant corruption, restless society, to name just a few. Most policy analysts therefore, believe that the top priority of the Xi-Li administration should be bold social and political reforms rather than economic growth. The Chinese growth has actually slowed down significantly since 2011 and some economists even warned of an imminent crash of the Chinese economy in the coming years. Without continued strong economic growth, the new regime may not have the necessary resources as well as the legitimacy to accomplish political and social reforms. What can be done to avert a potential crisis and rejuvenate the economy? There is no shortage of opinions and concrete proposals from economists and government-affiliated think tanks. The mainstream analysts have followed the liberal ideology and called for bolder market reforms. While sympathetic to the ultimate goal, we believe that placing faith solely on the courage of visionary leaders oversimplifies the political dynamics of economic reforms.

We believe reform strategy matters. Gradualism, in particular, can not only ensure the right sequencing is followed so reforms make good economic sense but also generate enough political support to overcome the resistance. Most reform proposals so far fall short in this regard. For example, some advocate reforming China's financial system as a major breakthrough. Financial liberalization, while necessary, may in fact trigger a crisis in today's Chinese economy if not accompanied by reforms in the real sectors. A lot of bank loans have been squandered by local governments and state-owned enterprises since the huge stimulus package was introduced after the 2008 world financial crisis. Once marketization pushes interest rates higher, the interest burdens may force them to default and banks will be saddled with piles of nonperforming loans. Market competition also reduces the profit margin for state banks, which leave them little room to absorb NPLs. In the aftermath of the 1997 Asian financial crisis, Chinese banks faced similar challenges and it was strong economic growth in the 2000s that enabled state banks to grow out of the NPL crisis. If this recent history offers any lesson, financial reforms should be introduced only with or even after changes are made in the real sectors.

To revive the real economy, some analysts call for reducing tax burdens shouldered by businesses. Like financial liberalization discussed earlier, while relieving tax burden is useful in principle, the timing is probably not right. The immediate threat to the Chinese economy is overinvestment and lack of sustained demand. Tax relief may put more yuans in businesses' hands and give them more time to hang on in today's tough environment, but it does not address the fundamental challenge of creating new growth engines. More importantly, those already highly indebted Chinese local governments are apparently not in a position to reduce tax. As a matter of fact, in 2012 the cash-strapped local governments are working very hard to collect more taxes from enterprises to make up the revenue shortfall due to growth slowdown and cooling land market. At the same time, the central government may need more fiscal revenues to prepare for the future slowdown. Therefore, the room for tax cut is at most limited.

Breaking down state monopoly in industries, like oil, steel, electricity, and transportation, necessary in the long run, is probably not the solution to the current problem either, given there is already significant over-capacity in these sectors. Moreover, for reform in these sectors to go through, detailed plans to defuse fierce resistance from the vested interests are yet to be laid out and the lack of such plans has derailed similar attempts in the past.

In our view, a reform package that centers on land and urbanization provides the best chance of unleashing huge domestic demand and relieving the overcapacity problem in many industries. We focus on land in this week policy proposal because land has played an essential role in the making of China's growth model in the past 15 years old and it is also responsible for current woes in the economy. Revenue centralization and expenditure decentralization since the 1994 tax-sharing reform left a big hole in local government budgets. In order to meet their spending obligations, local governments exploited their role as de facto owners of land and launched a massive drive for industrialization and urbanization. First, in order to attract mobile manufacturing businesses, especially foreign firms with huge export potential, to their jurisdictions, local governments raced against each other to offer the cheapest and most well-developed industrial parks. Requisitioning farmland became a national sport for local officials in both developed and poor regions. Second, to finance the costly infrastructure construction in industrial parks, local governments relied on urbanization to raise the necessary revenues. As de facto monopolists in local residential and commercial land markets, local officials limited land supplies through land banks and raised lease prices to land users. Finally, to leverage commercial and residential land, they must first improve urban infrastructure, such as highways, subway systems, railroads, airports, water and sewage networks, etc. Local governments set up lots of financing platforms, usually trust and investment companies for urban renewal, which used land as collaterals to obtain policy loans from state banks or used future land revenues and government guarantee to issue bonds to the public.

This land-based developmental model contributed to the dramatic rise of the Chinese economy, but the negative consequences are also numerous and obvious. First of all, government subsidies in industrial parks have resulted in excessive investment in manufacturing capacity, making China highly dependent on export markets. China invested around 40% of GDP in the 2000s and the ratio reached about 50% in recent years, significantly higher than the world average of 20%! Moreover, in their pursuit of mobile capital, local governments have inadvertently created an extremely pro-business regime. Farmers were under-compensated to lower land lease prices, labor rights were curbed to control wages, environmental laws were relaxed to save production costs, and housing prices were kept high to subsidize industrial land users. Economically, this regime weakened domestic demands and household consumption as a percentage of GDP declined from mid-40s in the 1990s to mid-30s in the 2000s. Social discontent also cast a dark cloud over political stability. Equally worrisome is the potential risk associated with the property market. Due to their distorted incentives, local governments have been propping up the housing and land markets. When the bubbles burst, not only will local governments be unable to continue their growth schemes, but the financial sector may also be dragged into a crisis because many bank loans are collateralized against the over-valued land.

Changing the course, however, is not easy. The old model has created its own vested interests and these actors, central and local, public and private, forged a strong growth coalition to perpetuate the existing path. In the aftermath of the 2008 financial crisis, the Chinese government's response was prompt and massive. It pledged four trillion government spending in two years as well as increased bank credits by 9.6 trillion in 2009 and 7.95 trillion in 2010. The irony is that, instead of boosting consumption, the stimulus money reinforced the existing imbalance in the economy. Flooded with cash, local governments constructed more ambitious industrial parks and giant state-owned corporations splurged on business expansion. Both contributed to further buildups in manufacturing in China. On the other hand, local government's urbanization scheme was kept buoyant by easy credits as well as speculative money. The centrally-controlled state-owned enterprises (SOEs) also heavily invested in the real estate sector, fueling a real estate bubble. In many third or fourth tier cities, housing prices more than doubled within one to two years. Land lease fees doubled from 1.59 trillion in 2009 to 3.15 trillion in 2011. These revenues combined with land-backed bank loans and bond sales enabled local governments to launch massive urban infrastructure projects, such as rail, subway, road, and airport, etc.

Despite the tremendous inertia, some reform in land can no longer be postponed. We propose a gradualist approach that aims to build a dual track system. Under the current land regulatory regime, land ownership is separated into urban and rural and only urban governments have the authority to take land from rural areas for urban development. This not only deprives rural residents of their development rights but also leads the Chinese economy down to a quite destructive path. Total liberalization, however, may result in a crash of the existing housing bubbles when large volume of rural construction land rushes to the market. To alleviate this concern by local governments and urban homeowners, China may need to first set up a rental property market track targeting mainly the 200 million rural migrants who already choose to live and work in cities. However, half of them live in dormitories provided by the employers and the other half resides in the illegally built housing in urban villages with poor infrastructure and no access to urban public services such as education for migrating children. We propose a reform that always rural communities in suburban villages of migrant-receiving cities to take their non-farming land onto the urban housing market with one condition: for the first 10-15 years, they can build properties only used for rental purposes. After the transitional period, however, these houses will gain full rights and can be sold directly on the housing market.

This design has a number of advantages. Insulating rural construction land in the rental market initially provides a cushion for the existing housing market and prevents market panics and a crash of housing bubble. On the other hand, eventually merging the two tracks in the future sends a credible signal to the speculators that housing prices would not rise further, therefore, the central government can phase out its strict regulations on real estate markets installed since 2010 to curb the housing bubble. Both contribute to a healthy growth of the housing market. Moreover, granting rural community the development rights (even though restricted during the transition) opens the legal channel for them to apply for bank loans for development. This can unleash a housing construction boom in urban villages and suburban areas, which provides a lift for construction-related industries with significant overcapacity. Finally, unlike the current housing bubble, this kind of real estate development is more socially beneficial and economically sustainable. Rural residents, particular those living close to urban centers, benefit from this change directly. The growth in the rental property track also makes housing affordable for hundreds of millions of migrant workers, enabling them to settle in cities permanently. Urbanization holds the potential of turning the Chinese economy away from the investment-driven model.

One key to the success of this reform lies in the attitude of local governments. Their concern over revenues is perfectly legitimate and needs to be addressed in the reform package. Under the current system, local governments are burdened with too many spending responsibilities but do not have adequate revenues. After the reform, they will have limited power of land requisition and lose the sizable land lease fees and bank loans associated with that power. In the long run, property taxes should be levied so that local public finance can be supported by a stable source of income. Considering the strong resistance from the wealthy and the politically powerful in the trial cities, however, it is unrealistic to expect this new tax to take effect soon. In our view, the loss of revenue during the transitional period will be compensated by several sources.

First , the urban and suburban villages that are lured by the huge rents and join the proposed rental market track would be happy to contribute some of their land for free to the local governments in return for their newly gained land development rights for rental housing. For example, local governments would be authorized to take 50% of rural land from these communities and use 30% for infrastructure construction, such as roads, water and sewer, public schools, hospital, etc. Local governments can auction off the remaining 20% of land to raise capital for these constructions. The development rights for the remaining 50% of land would be granted to the original land owners, the villager. The latter would be better off since the remaining 50% of land would value more due to improved infrastructure and a higher development intensity authorized by the government. This technique, known as land readjustment, is an effective way for government to capture the land value appreciation in urbanization. Local governments would then be able to spare themselves from paying for infrastructure improvement from their own budgets. In addition, the proposed rental market also generates handsome rents and local governments can levy a tax on these rental incomes and use the revenue to cover the education expenditures for migrants' children in urban public schools. Once the housing and schooling issues are settled, China would be able to accommodate hundreds of millions of migrants on a permanent basis. They would work, live and consume like urban residents, a further boost to domestic demand.

Moreover, for those rural communities that have already developed their land "illegally" for urban usage, a gradual process of legalization can be started if certain infrastructure and building standards are met and due taxes are paid. The land and house owners would be willing to pay to local governments to gain full legal status.

Finally, another untapped source for local governments is the under-utilized industrial land. According to various reports, the floor-area-ratio is only about 0.3-0.4 for industrial parks even in China's developed areas. Through reorganization by negotiation, it is possible to double land development intensity and to convert some industrial land for residential and commercial construction. According to our estimates, at least one million mu industrial land should be available for such conversion each year. Assuming 750,000 yuan per mu for housing and commercial land (2008 price), local governments can collect 750 billion yuan per year for the next 10years. Further assume that 2/3 of this converted land is used for housing, with a floor-area-ratio of 1.5, about 600 million m^2 houses would be built each year. With a moderate price of 5,000 yuan per m^2, local governments can raise 420 billion yuan in real estate related taxes.

Even with some moderate assumptions, one can show that local governments should be more than compensated for giving up the power of land requisition. They can also use these revenues to pay back the debts incurred through financial platforms and avert a financial bomb.

At the current stage of development, no reform in the Chinese economy is going to be easy.One certainly should not have any illusion about a quick fix. But the proposed dual track reform package offers some real hope of boosting domestic consumption and alleviating the overcapacity problem in many sectors. One particularly favorable factor for this reform is the new leadership's emphasis on urbanization. Premier Li Keqiang has spent years on this issue and seems to have a genuine interest in making breakthroughs. This proposal may provide a realistic roadmap for such reforms.