

Alternatives to Debt-driven Growth: Continuing in China's 40 year of Reform

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Executive Summary:

For the past decade or more China has been engaged in a major reform of the economy, moving away from the manufacturing export led growth model to one based on domestic demand. Too much of China's growth over the past decade (and even earlier) was financed by debt. There is an increasing consensus that the rate of accumulation of debt is not sustainable.

High levels and rates of increase of debt are associated with a higher probability of having a crisis. Resources get wasted in crises, and there is typically much suffering. But there is also typically a waste of resources *before* a debt crisis hits.

At the local level, to too large an extent, there is an alternative finance mechanism which is problematic in still other ways: selling off government land. It has been associated with corruption, poorly managed urban areas, and, again, the misallocation of resources.

In the private sector, there has been considerable institutional innovation in the provision of finance, but many of these innovations have resulted neither in

¹ University Professor, Columbia University. Background paper prepared for 2018 China Development Forum. I am deeply indebted to Mo Ji for her comments on an earlier draft. In this note, I am returning to themes that I wrote about for the China Development Forum in March, 2007 (**Towards a New Model of Development**) and for discussions in Beijing in December, 2015 in a meeting convened by the premier on China's 13th Five Year Plan (**The Next Stage of China's Economic Strategy - with a Focus on 13th Five-Year Plan and Reflections on China's 13th Five Year Plan**). Those discussion papers talked about several aspects of the move towards domestically driven growth, including how systems of better social protection would allow households to consume a larger fraction of their income, again reducing the need for debt-financed growth, the major theme of this note.

increased efficiency or stability. While there is a need to tighten financial regulations, ensuring that more lending is intermediated by well-regulated banks, and on-lending is not allowed, it is important to look for other ways of financing domestically driven expenditures.

This paper looks at two such ways, taxation for the financing of public sector expenditures and equity for that in the private sector.

There is much scope for increased tax financed growth in China. Well-designed taxes can actually increase—or at a minimum do not impede—the efficiency of the economy, *stimulate* domestic demand, and address other key problems facing the Chinese economy and are consistent with principles of equity.

The paper looks at the benefits to be achieved from carbon taxes, a financial transactions tax, including on cross-border capital flows, capital and inheritance taxation, and property, land, and natural resource taxes.

The paper explains the advantages of equity finance over debt finance, but success in this area requires a better institutional framework for ensuring transparency and good accounting standards, with strong systems of accountability.

The shift to greater reliance on taxation and equity finance can not only enhance economic and financial stability; it can even improve the efficiency and equity of the economic system. And this would be the best way I believe, for China to continue in its 40 years of reform.

Alternatives to debt-driven growth: continuing in China's 40 year of Reform

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For the past decade or more China has been engaged in a major reform of the economy, moving away from the manufacturing export led growth model to one based on domestic demand—demand for goods and services arising from rising consumer income, and private and public investment, including investments to create an innovation economy and to create modern cities as China continues on its path of modernization and urbanization.

This note looks at one aspect of this domestic demand driven growth: how to finance it. Too much of China's growth over the past decade (and even earlier) was financed by debt, to the point where China's debt to GDP ratio reached 257% in 2017, one of the highest levels of leverage in the world (vs. Japan over 400% of GDP, and US 152% of GDP in 2017). There is an increasing consensus that the rate of accumulation of debt is not sustainable—it has increased from 152% in 2007—a period of just 10 years.²

One might say, not to worry, since most of the debt is household and corporate debt. But that should provide little comfort. We know how easily private debt can morph into public debt, and this is especially true since some 60% of the corporate debt is that of government enterprises.

If China were a conventional market economy, I would be deeply worried by these debt levels, and many economists are. But China has a very high savings rate, a relatively high growth rate, and is sitting on three trillion dollars of

² It was these concerns that motivated my analyses mentioned in the previous footnote.

reserves. China has the resources and the instruments to manage its way through a debt crisis. China undoubtedly has an easier time managing some of the distributive consequences of debt restructurings.

Still, there is cause for concern. Whenever debt increases rapidly, standards of underwriting deteriorate; bad loans get made. The result is that capital is misallocated. There is a waste of resources *before* a debt crisis hits, even if the crisis is perfectly managed. And managing such crises is not easy. In retrospect, it always seems that they could have been managed better. There are always uncertainties, worries about setting a bad precedent, concerns about justice when those responsible, either for the bad lending or the bad borrowing, are not held accountable.

At the local level, to too large an extent, there is an alternative finance mechanism which is problematic in still other ways: selling off government land. It has been associated with corruption, poorly managed urban areas, and, again, the misallocation of resources.

Further problems of debt finance in an evolving economy

Banks are the institutional arrangement through which loans have traditionally been issued, and good banks have developed structures for evaluating and monitoring loans. There is also a system of accountability, provided the bank is adequately regulated—if the bank makes a bad loan, it bears the loss.

But there are economic forces in play in many countries undermining this well-established system. Of course, banks themselves would like to undertake greater risk with less capital than good regulators should allow; for then, it's a one-sided

bet—if the risks turn out badly, someone else picks up the tab, either the government, or depositors, or bondholders.

If banks fail to convince regulators to weaken regulations, then a system of “regulatory arbitrage” comes into play, trying to circumvent the regulations in one way or another. The dangers were evident in the run up to the US financial crisis.

More generally, capital markets often provide loans without the institutional rigor of screening and monitoring loans provided by banks. Capital markets can work well in the case of the issuance of bonds of large corporations, where many analysts are monitoring their actions. (Even with monitoring of many analysts, there still can be fraud. That’s why it’s so important to have strong securities laws, strongly enforced.) But capital markets work less well when the borrowers are small enterprises or where what is being traded are securitizations or other complicated financial products. In the US, the credit rating agencies failed to provide adequate risk assessments, and there are inherent reasons to expect such failures.

At one time, there was the hope that internet lending based on peer monitoring would provide an alternative way of providing funds to small enterprises, but by and large it has proven a disappointment. To me this is not surprising: it seemed unlikely that this system will solve the information problems associated with screening and monitoring. There were again good theoretical reasons to expect that this system would not work.

When there is a disparity between the rate at which large enterprises can borrow and that at which they can lend, there is an incentive for these enterprises to turn

themselves partially into banks. GE did that in the United States, and has now reconverted itself back into a normal enterprise. But lending is typically not in the core competencies of these enterprises, and that makes such lending particularly risky, both for the enterprise and for society.

In short, some of the institutional innovations in the arrangements by which lending occurs have, by and large, not worked well. Risk has increased disproportionately. One approach is to tighten financial regulations, ensuring that more lending is intermediated by well-regulated banks, and on-lending is not allowed. This should, in any case, be done.

But one should simultaneously look for other ways of financing domestically driven expenditures. This paper focuses on two such ways, taxation in the public sector and equities in the private.

Taxation as an alternative to debt driven growth³

There is much scope for tax financed growth in China. Well-designed taxes can actually increase—or at a minimum do not impede—the efficiency of the economy, *stimulate* domestic demand, and address other key problems facing the Chinese economy and are consistent with principles of equity.

The most important tax is a **carbon tax**. Global emissions of greenhouse gases represent a threat to our planet. China should focus on sustainable growth, and growth can be sustainable only if it is environmentally sustainable. Moving to a

³ The discussion papers referred to earlier elaborate on the importance of property, capital gains, and environmental taxes.

low carbon economy would have side benefits in leading to a reduction in other pollutants which have made the air in many Chinese cities barely breathable.

A recent international Commission which I co-chaired along with Lord Nicholas Stern⁴ concluded that if we are to achieve the climate targets established in Copenhagen and Paris, limiting the increase in temperature to 1.5 to 2 degrees centigrade, we need a carbon tax of around US \$50 to \$100 in the medium term. Such a tax is the most efficient way of inducing firms and households to limit their greenhouse gas emissions—though it has to be accompanied by other measures, including regulatory measures, appropriate government investments, including public transport systems, and the design of efficient cities.⁵

The carbon tax can incentivize households and firms (and local governments and other entities) to reduce their carbon emissions. As it does this, they are encouraged both to innovate and to make investments, and these in turn actually stimulate domestic demand. Thus it simultaneously improves the environment, raises revenue, needed for instance by the government for other public investments and increased expenditures on health and education, and continues the shift from export driven demand to domestically driven demand.

A financial transactions tax can simultaneously raise considerable revenue and reduce socially unproductive excess trading in financial instruments.

⁴ The High-Level Commission on Carbon Prices of the Carbon Pricing Leadership Coalition, Report published May 29, 2017 by the International Bank for Reconstruction and Development and International Development Association/ The World Bank.

⁵ Premier Li Keqiang committed in his Government Working Report to continue the favorable tax treatment of electric cars is a move in the right direction. Alternatively, he could have increased the tax on gasoline cars, especially those which are not energy efficient.

A tax focused on short term cross-border capital flows can contribute to macroeconomic stability; such cross-border capital flows have proven a central to macroeconomic instability in Asia and elsewhere around the world. In recent years, even the IMF has changed its position on capital market liberalization, recommending that countries engage in capital account management. One of the central tools in such capital account management can be taxes, both on short term capital inflows and outflows.

Most countries are worried about insufficient savings, and therefore, as desirable as capital taxation (especially capital gains, and especially capital gains associated with land) might be, they worry that such taxation might reduce savings. But China is in the opposite position of most of these countries, as it wants to encourage domestic consumption; as a share of GDP this is markedly lower than in other countries (though mostly because the share of household income in GDP is low.) Accordingly, raising capital taxation would improve equity (by reducing long run inequalities of wealth, one of the most important and growing dimensions of inequality) and raise revenues to finance domestic public expenditures.

There is another argument for taxing capital at a high rate in China. China has seen one of the most rapid build-ups in inequality in the world, so that today, by most measures, China's inequality is comparable to that of the United States, the most unequal country in the advanced world. Inevitably, large advantages get passed on from one generation to another; a country with large inequality of income and wealth cannot have equality of opportunity. And since inequality of

wealth is one of the major sources of inequality, **capital and inheritance taxation**, at high rates, are essential for reducing wealth and income inequality.

Another related source of much of the growth of inequality in China is land.

Those able to acquire land from townships and villages and other public bodies at low prices, or even those who obtain the right to develop the land, can become rich overnight. So too, because of the rapid increase in land prices, those who owned land at the right time and in the right place have become very wealthy. These are windfall gains, not primarily the result of industry and effort. Taxing these capital gains at high rates would thus raise considerable revenues and reduce inequalities, with little adverse effects on economic efficiency.

There is a further advantage. Because there has been so much money made off of real estate, too much of society's resources and talents are devoted to real estate. Those looking for assets into which to put their retirement savings would be induced by a **high property tax** to shift away from real estate to more productive investments.

Those who have made their fortunes in real estate always appeal with concern about the well-being of small property owners, those whose only asset is their home. It is, they would say, unfair to impose a tax on them, when they have already paid for the property. Such an argument could be used against the imposition of any new tax, or indeed any new regulation: it is unfair to those who made investments before the tax or regulation was imposed. Taking the objection on face value would imply a halt to any change, as desirable as that change would be. Indeed, cigarette manufacturers producing products known to kill have made such an argument even against mild regulations requiring the

disclosure of the harmful effects of cigarettes, for such disclosures do lead people to stop smoking and thus do impair the value of those investments. Such arguments are merely self-serving, and stand in the way of governments fulfilling their public functions. Of course, governments have to be sensitive to the distributive consequences of all policies; in this case, those with low incomes or low wealth holdings could be made exempt from the tax.

A similar argument for a **land tax** applies to all other natural resources. Those resources rightly should be viewed as part of the patrimony of the country, belonging to all citizens. Sometimes, in one way or another, some group has obtained the rights to those resources, typically paying far less than a fair market value. Capital gains taxes and excess profits taxes can be used to recoup for the state some of the excess profits. In the case of China, many of the country's natural resources have been entrusted to state owned enterprises. But the employees and managers of these should not be the only ones that gain from the value of the underlying resources.

Greater Use of Equity Financing

While increasing public expenditures (at all levels) financed by taxes rather than debt could, by itself, constitute a major shift away from debt-financed growth, there is one more instrument for the corporate sector: financing expansion beyond retained earnings through the issuance of new equities, as the Chinese premier advocated in the Government Working Report for more equity financing in 2018 and beyond. There has already been extensive growth of equity markets, but still, corporations are too reliant on debt. The full development of the equities market in China will require the development of a better institutional

framework for ensuring transparency and good accounting standards, so that instances of fraud and misrepresentation become rarer. In all countries in early stages of development, especially in periods of rapid growth, there are those who are less than scrupulous, or whose enthusiasm for growth overcomes their better judgment.⁶ Harmonizing standards for reporting for capital markets and reporting for tax authorities will further incentivize good accounting, for then misreporting becomes a crime against the state as well.

Equity has a marked advantage over debt. When the fortunes of the company turn out to be less than expected, perhaps because of a cyclical downturn, perhaps because of unanticipated changes in market conditions, there doesn't have to be a costly debt restructuring. But with equity, the profits are supposed to be shared equitably among all the shareholders, and managers and the original owners often have the means of shifting profits towards themselves. But if enough firms do this, there will be no confidence in the equity markets. Confidence in the equity market can only be assured through good norms and regulations, rigorously enforced.

Concluding Comments

When China's economy was smaller and less complex, economic experiments were easier and so too were course corrections. On several occasions, there has been government intervention in the banking system, as a result of mounting bad loans. But China's economy has grown enormously, and the management of the economy has grown commensurately more difficult.

⁶ Recently reported tightening of standards for listing in Chinese markets is a positive sign of a move in the right direction.

No decision is of greater importance than the allocation of scarce capital. The long history of economies that have been too dependent on debt or let debt increase too rapidly shows that resources get misallocated and problems follow. This is partly that, even in an efficient market, as one invests more, one has to go down the list of projects, taking on those with greater risk and lower returns. But it is also that typically, when the pace of lending increases, the quality of risk assessment deteriorates. Individuals with less training and experience in risk assessment get engaged in the credit allocation process. Regulators and supervisors become overburdened, and thus more bad lending escapes their scrutiny. Moreover, periods of rapid lending are often associated with bubbles, like the tech bubble and the real estate bubbles in the US. (There is again typically a causal link: the rapid lending helps create and sustain these bubbles.) Such bubbles make the assessment of risk more difficult. Regulators in the US, who denied that there was a real estate bubble, thought that the real estate loans that were being made were safe, because the value of the collateral more than sufficed to cover the loan. They mistakenly increased the loan to value ratios just at the time they should have reduced them. Thus, good regulatory policy needs to be particularly sensitive to credit-created bubbles, which can take on many forms, and engage in countercyclical regulatory policies, for instance decreasing the loan to value ratio at the first signs of the possibility of a bubble.

Particularly when the rapid expansion of credit is associated with low interest rates, regulators need to be concerned about market irrationalities that typically then appear in the pricing of risk: a search for yield drives down risk premia, and there is systematically excessive risk-taking.

The concerns about China's excessive dependence on debt finance, and the excessive levels of leverage, I believe are becoming increasingly justified. That's why it's imperative to find other ways of financing China's domestically-driven growth.

In the coming years, China will need high levels of public expenditures, both public services (education and health) and investments (infrastructure and technology), at all levels of government. These public expenditures can and should be an important part of China's move towards domestically driven growth; but especially at the local and provincial level, there should be greater reliance on taxation, not on debt or land sales. In the private sector, there needs to be greater reliance on equity, but robust equity markets require high standards of transparency and accounting, rigorously enforced.

There is no magic formula determining the right balance either in the sectoral allocation of GDP or in patterns of finance. The right balance will differ from country to country, from time to time. Sometimes, though, it is easy to determine marked imbalances—situations in which it is unambiguous that changes in patterns of expenditure and finance that would enhance societal well-being, through increased growth, reductions in inequality, and greater stability. Looking at the US, we can say that there is too much consumption, too little of both private and public investment, too little public expenditures on infrastructure, education, health, and research. At the current time, we can also say that government spending is too much debt financed, with projected levels of debt accumulation that may be unsustainable. China is in a very different position. There is a consensus that it should move to more domestic demand

driven growth. It has a saving rate that is too high; resources are often misallocated. Thus, consumption should be increased, but much of the increase in consumption should be financed through government—for education, health, and, especially for those of limited means, housing. There is ample fiscal space for this expansion of public expenditures, but the right way today to finance these additional expenditures is through increased taxes. The private sector too, we have noted, is excessively financed through debt. A move to equity would lead to greater efficiency and stability, but only if the right institutional structures are put into place.

The shift to greater reliance on taxation and equity finance can not only enhance economic and financial stability; it can even improve the efficiency and equity of the economic system. And this would be the best way I believe, for China to continue in its 40 years of reform.