Reflections on China's 13th Five Year Plan[1]

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China has made remarkable progress since it embarked on its journey towards a socialist market economy with Chinese Characteristics. At each stage of its development, it has adapted its strategy to reflect the advances made in the previous, and the changing global situation. The 13th Five Year Plan is being formulated at a time of significant slowdown in global economic growth, with the world facing critical challenges of climate change and growing inequality. China faces additional challenges posed by urbanization, demographics, and pollution, the structural transformation towards a service and innovation economy and domestically demand driven growth, away from export led growth.

This note addresses two issues—the immediate issues facing China, including the debate over the mix of supply and demand side measures to maintain growth in the short run and provide the basis for China's longer time success; and the longer term issues which should be at the center of the 13th Five Year Plan.

China's Current Macro-economic Situation

In the last few months, there have been global concerns over China's slowdown, the devaluation of its currency, and stock market volatility. Much of the concern over devaluation and market volatility, I believe, is misplaced. The center of attention should be on the real economy. Before turning to those issues, let me say a few words about the events in the financial sector.

Financial turmoil

The big lesson to be learnt from recent financial turmoil is that *markets with Chinese characteristics are as volatile and hard to control as markets with American characteristics*. Markets with either Chinese or American characteristics take on a life of their own, and they cannot be easily ordered around. This was the path Deng and China chose four decades ago. To the extent that markets can be controlled, it must be done with more subtlety, through setting the rules of the game, including the regulations governing markets e.g. transparency requirements. Some of what has gone on is a move in the wrong direction: there is a distinct lack of transparency in the policy framework. Those arguing that what China needs is more financial and capital market liberalization are, in effect, arguing for an institutional framework that is likely to be marked by even more volatility.

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There are several other insights from what has happened: markets need rules and regulations; good rules can help stabilize markets; badly designed rules, no matter how well intentioned, can have the opposite effect. Thus since the stock market crash of 1987 in the U.S., the value of circuit breakers has been recognized; but if they are not well-designed, they can increase volatility. If there are two levels of circuit breaker (a short term suspension, and a long term one) and they are set too near each other, once the first is set, market participants, realizing the second is likely to become operative, can become more active in fleeing the market.

There are other lessons: what happens in markets may be only loosely coupled with the real economy. This Great Recession illustrates: the US stock market had a robust recovery, while the real economy remained in the doldrums. Still, stock market and exchange rate volatility can have *real* effects. Uncertainty may lead to lower consumption and investment. That is why governments should try to have rules that are conducive to stability.

What matters more though are the rules governing the real economy. Market volatility has distracted attention from these, which are far more fundamental. It is worth noting that in most economies, there is little connection between the stock market and the real economy; little funds for investment are even raised in the stock market. But the connection is especially weak in China, with its immature stock market. Chinese economic performance since the beginning of economic reform and opening to the World is totally unconnected with the performance of the Chinese stock market.

The real economy

After long anticipating the need to move from export driven growth to domestically driven growth, from quantity to quality of growth, there have been more bumps on the road that some anticipated, exemplified by stock market and exchange rate volatility. By historical standards, China is still growing well—at near 7%, some might say *very* well—but success breeds high standards.

Still, the macro-economic risks facing China are serious, and a significant slowdown below current growth levels would put in jeopardy the ability to deliver on promises of income increases and put at risk economic and financial stability—China's economy is structured around maintaining robust growth. Moreover, a significant slowdown would jeopardize the entire reform agenda. In this context, one has to be especially sensitive to the sequencing and pacing of reforms.

There is an on-going debate on the balance between demand side and supply side reforms. One has to assess this issue in the context of the current global slowdown—the most significant of this century with the exception of the global financial crisis in 2008 and the recession at the beginning of the century. In the era of China's earlier export led growth, there was little limit to the demand for China's products. What China made, the world bought. But China is in a different position today for several reasons. It is moving away from export led growth to domestic-demand driven growth, in which the non-traded sector is increasingly important. And there are limits to the demand for these non-traded goods, provided by the level of national income. Macro-economic policy thus becomes increasingly important. Moreover, as China's share of global manufacturing increases, there are even limits to its ability to export more, without significant decreases in prices, which erode profit margins, putting at risk the viability of enterprises and the sustainability of growth. Thus China simply cannot ignore aggregate demand.

The stronger the demand-side measures, the stronger can and should be the SOE reforms. Moving workers from low productivity uses to unemployment lowers growth, and markets won't create jobs on their own—particularly in the context of an overall macro-economic slowdown. Moving workers from low productivity uses to dynamic sectors promotes growth now and in the future; but that *structural transformation* too won't happen on its own.[2]

To repeat, China needs stronger demand side measures now. These can, if well-designed, have significant positive supply side effects over the long run. Without the demand side measures, supply side measures may be counterproductive, even if they were to be appropriate in the long run. It is simply wrong to assume that "supply creates its own demand."[3] But, as I shall comment below, some of the allegedly supply side policies associated with financial sector reform may weaken growth today and in the future, even as they increase inequality and instability.

Demand side measures that improve supply over the medium term

Fortunately, there are many forms of spending and many instruments that China could use to maintain growth—and sustained increases in well-being—many of which are complementary to what should be other goals of the 13th Five Year Plan. The move from export led growth to domestic demand driven growth thus entails more than just increasing private consumption. Some of the most important measures center around investment, some around private consumption, and some around publicly provided consumption goods, like environmental enhancement, preservation and restoration; health; and education.

If China is to avoid the extremes of inequality seen in the West, there needs to be reliance on the public provision of public goods like environmental protection, health and education. Public goods are intrinsically equalizing because everyone, regardless of whether he or she is rich and poor, can enjoy them equally. Provision of public services (health, education) and social protection[4] would, in addition to the direct benefits that they generate, lead to more domestic consumption, again facilitating the transition to a domestic demand driven economy, and mitigate some of the problems of excess supply.

Increasing climate and other investments aimed at improving the environment and pro-equality policies would add to domestic demand. So too for the large investments that will be required to make China's

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[2] See Domenico Delli Gatti, M. Gallegati, B. Greenwald, A. Russo, and J. E. Stiglitz, "Mobility Constraints, Productivity Trends, and Extended Crises," with, *Journal of Economic Behavior & Organization*, 83(3): 375– 393; and See Domenico Delli Gatti, M. Gallegati, B. Greenwald, A. Russo, and J. E. Stiglitz, "Sectoral Imbalances and Long Run Crises," in *The Global Macro Economy and Finance*, F. Allen, M. Aoki, J.-P. Fitoussi, N. Kiyotaki, R. Gordon, and J.E. Stiglitz, eds., IEA Conference Volume No. 150-III, Houndmills, UK and New York: Palgrave, pp. 61-97.

[3] This idea is called Say's Law. Economic science has firmly rejected it.

[4] I have elaborated on these issues in a note prepared for the 2016 China Development Forum, entitled "Building the fairer and sustainable social security system".

cities livable for all of its citizens. (This will include parks and public transportation systems. I first addressed the issues of urbanization in a talk I gave in China in 1998 as Chief Economist of the World Bank.) Later in this note I discuss investments in technology, as China moves to becoming an innovation economy.

Social returns from these kinds of investments far exceed the costs of capital. The fact that there are some investments that were made in the past that did not yield high returns is not a persuasive argument against undertaking these investments. The private sector misallocated massive amounts of capital in the run-up to the global financial crisis, with a total societal cost in the trillions of dollars; no one is suggesting that the implication of this history is that the private sector not be entrusted with investment going forward.

Many of these public investments would, in fact, increase both the productivity of the private sector and, to the extent that public and private investments are complementary, increase the demand for private sector investment. They thus can have a large demand multiplier—increasing aggregate demand by far more than the spending itself.

There are, however, two lessons that do emerge from the past mistakes. The first is that there needs to be a much broader range of investments than real estate in the private sector and transportation in the public. The previous paragraph suggested the broad range of productive investments that could be made.

From debt to tax financed expenditures

The second is that too much of the earlier investment was debt financed. This critique of the debt financed response to the 2008 crisis is part of a broader critique of the demand side measures taken in response to the 2008 crisis. These were far from perfect, and had to be formulated *on the fly, in the context of an unexpected emergency.* One has to remember the context: an unprecedented drop in trade, greater than the Great Depression, would inevitably have deep effects on any export dependent economy (as China was then) in the absence of stimulatory measures. Indeed, early on, 20 million migrant workers lost their jobs in 2008 crisis. In any country, that level of job loss would demand a strong response. Thus, even these measures, imperfect as they may have been, were far better than having done nothing: it is better to have resources used in ways which may not be optimal than unemployed, and in the absence of adequate government demand side measures, there would have been substantial unemployment.

In the private sector, a more regulated and stable equity market would provide greater scope for equity finance. [5] In the public sector, China has ample room to increase its tax base, and in ways which would increase overall efficiency and/or equity.

Reforming public finances, at both the local and national level, can be an important part of achieving the goals of the 13th Five Year Plan. Well-designed regulations can actually improve the allocation of resources and promote economic growth. **Environmental taxes** (including a carbon tax) can generate substantial revenues and provide better environmental incentives, leading to cleaner air and water. **Capital gains taxes** can reduce inequality, discourage excessive speculation, leading to a reallocation of resources (especially scarce human resources) to more productive uses, and raise revenue. **Financial transactions taxes** can reduce excessive, destabilizing financial transactions. More broadly, the tax system should be designed to encourage innovation and discourage rent-seeking activities.

Property (land and resource) taxes, if well designed, can increase equality and are among the most efficient taxes, since they do not distort the economy. In fact, land (property) and capital gains taxes will lead to greater investments in productive investments, promoting growth. The current system of financing local governments largely through land sales is particularly distortionary. **Congestion taxes** will make cities more viable.

Inheritance taxes can help reduce the intergenerational transmission of advantages, increasing equality of opportunity and decreasing inequalities in income and wealth at the same time that they not only increase government revenues but even stimulate current demand. **Progressive taxes** can raise revenues, reduce inequality, and even reduce incentives for distortionary rent seeking. [6]

In addition, taxes and regulations leading corporations, including SOEs, to distribute more of their profits, giving the governmental entities that own them more revenue to undertake the public expenditures described earlier; and policies aimed at increasing wages (and thereby increasing consumption) could correct one of the most anomalous aspects of China's economic structure—the low share of household income in GDP.

Some might worry: won't raising taxes depress the economy, offsetting any benefits from the increased expenditures. Here, economic theory provides a clear answer, in the form of what is called the *balanced budget multiplier.* Increasing taxes and expenditures in tandem—so there is no increase in borrowing—stimulates the economy; and if the taxes and expenditures are well chosen, the stimulus can be very large (for instance, taxes on inheritances and capital gains matched with increases in spending on health and education or greater spending on social protection).

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[5] China needs to create incentives for investors to buy and hold shares for long periods, and needs to ensure that corporate governance regulations encourage long term investing, rather than the short termism that characterizes some Western economies. There are many instruments. Much higher capital gains taxes on short term holdings would encourage long term investment. Loyalty shares, where voting rights depend on the length of holding shares, would encourage longer term investment.

[6] For a further discussion of these issues, including some of the empirical support behind them, see J. E. Stiglitz, *The Price of Inequality: How Today's Divided Society Endangers Our Future*, WW Norton, April 2013.and J. E. Stiglitz *et al, Rewriting the Rules of the American Economy,* W.W. Norton, November 2015.

The dangers of backward looking supply measures

Not only is there a danger of a lack of balance between demand and supply side measures and a concern about the pacing and sequencing of supply side measures; there are worries that insufficient emphasis might be placed on the most effective supply side measures.

In some quarters, there has been too much emphasis on backward looking supply side measures: to take the US example, resources were wasted when shoddy homes were built in the middle of the Nevada desert. The first priority going forward is not to knock known those homes (in an attempt to consolidate housing), but to ensure that in the future resources are allocated efficiently. The basic principle taught in the first weeks of an elementary economics course is by-gones are by-gones (or to use the aphorism, don't cry over spilt milk). Low cost steel (provided at prices below the long term average costs of production or at or above the margin cost of production) may be a distinctive advantage for other industries. American firms gained enormously from excess capacity in fiber optic fibers in the 90s. It would have been a mistake to destroy this excessive capacity; there is always an "option" value associated with potential uses; this has to be contrasted with the minimal cost of maintenance.[7]

Measures to consolidate certain sectors (like steel) are likely to have winners and losers, and one should be aware of these as one assesses the political economy of such reforms. The large producers formed as a result of such mergers may well have market power, and use that market power to extract for themselves "rents" from the rest of the economy.[8] The lesson to be learned from Western economies is that, once created, such market power is hard to regulate or subsequently reduce. Economies with large rents are typically less efficient over the long run, even if there are productivity increases in the short run. Over the long run, excessive consolidation is an "adverse" supply measure. The winners in the consolidation are the large, more efficient firms that will dominate in the new industrial structure. The losers are the workers in the steel mills that will be shut down, the communities that they live in, and those who will have to step in to provide them with basic support.

If the economy were facing a situation of *excess demand* and a shortage of labor, then presumably they would remain unemployed only for a short time. But this is not the situation in China today; and we know that economic downturns can be long lasting—and there is nothing about China's economy today that assures us that, in the absence of demand supporting measures, that would not be true in China. In short, if there were excess demand and if inefficient steel mills were holding back China's restructuring *because of the resulting shortage of labor* then a policy of cajoling the restructuring might make sense. But that is not the circumstance in which China finds itself today.

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[7] Korea provides another telling example: in the 1998 East Asian crisis, there was considerable pressure for Korea to get rid of its excess capacity in chip production. After the cyclical recovery a couple years later, it turned out fortunate that Korea had not done so.

[8] There are potentially large distortions on the economy, even if some of the rents are used to provide income support to laid off workers. The rents, arising out of market power, can be viewed as a tax imposed on the consumers of the products; but such taxes are particularly distortive. It would be far preferable to have a more open system of support, financed out of general revenues.

Some call attention to a macro-deflationary problem. The presence of excess capacity contributes to downward pressure on prices, with negative externalities on other firms with debt, which see their real leverage increase.[9] But a far better approach than anti-competitive supply side consolidation is aggressive demand side expansion, countering any such deflationary pressures.

Much of the support from those advocating supply-side measures comes from those who believe in markets. I shall return to the broader issues later. For now, I simply note an intellectual inconsistency: if markets worked well, efficient consolidation would happen on its own.[10]

Other supply side measures that are not likely to work

There are many other supply measures, supposedly designed to increase labor force participation, savings, entrepreneurship, and productivity more generally that are unlikely to do so—and indeed pose the risk of being counterproductive on both the demand and supply side. Financial deregulation is often put forward as a supply side measure. The evidence is that financial deregulation has had just the opposite effect[11]; and good reregulation would be a supply side measure that might actually work. We discuss this in the next section.

Another example of an ineffective supply side measure is a general reduction in corporate taxes. Because most investment is financed through debt and debt is tax deductible, lowering the tax rate actually increases the *net* cost of capital. Both theory and evidence suggest that lowering of the corporate tax rate does not have significant positive effects on investment.[12] There are corporate tax reforms that might induce investment; for instance, lowering taxes on those who invest in the country and create jobs, and increasing taxes on those that don't.

Supply Side Measures that work in the short and long run

[9] At the same time, it should be noted that if workers suffer a substantial reduction in their income, their consumption will inevitably fall, and thus this "supply side" measure will actually have an adverse demand side effect, possibly exacerbating deflationary pressures.

[10] The story is obviously more complex: in some case, local authorities have an incentive to have the firm keep producing, so that the burden of providing for these workers remains largely with the enterprise. But the social costs of supporting these individuals is real. There are two other explanations for why markets might not restructure efficiently: First, local governments may be captured by local firms; and secondly, markets may not fully recognize option value—but this suggests that they will do too much restructuring. So too, if the central government forces a restructuring, but forces local communities to bear the unemployment/transition costs, there may be excessive restructuring.

As we noted earlier, it would be better to have a more transparent system of social protection, and such a system needs to be financed centrally.

[11] Again, it has also had an adverse aggregate demand effect. It has led to more inequality, and since as we have noted those at the top save far more than those at the bottom, the increase in inequality that to which it has contributed reduces aggregate demand. See J. Galbraith, *Inequality and Instability: A Study of the World Economy Just Before the Great Crisis,* Oxford University Press, March 2012.

[12] See, e.g. J. E. Stiglitz, "Taxation, Corporate Financial Policy and the Cost of Capital," *Journal of Public Economics*, 2, February 1973, pp. 1-34. More recently, Korinek and Stiglitz have shown that in a market economy, lowering the tax rate on dividends may actually reduce investment. See A. Korinek and J. E. Stiglitz, "Dividend Taxation and Intertemporal Tax Arbitrage," *Journal of Public Economics*, 93(2009), pp. 142-159

Earlier, we described investments that were simultaneously demand and supply measures, which moved the supply curve out in the medium term even as they increased demand today. In this section, we discuss a number of other "supply side measures," which over the long run will have a far greater effect on economic growth than consolidation. While lip service is often paid to some of these, what is needed is concrete policy measures. Many of these measures require fiscal expenditures; but for the government to be able to do this will require an increase in taxes.

Regulatory measures

Earlier, I discussed proposals advocating consolidation. One of the most important supply side measure leans in the other direction—promoting competition. Government policies should focus on *preventing excessive consolidation.* Using competition policy to ensure that firms do not consolidate excessively and do not abuse market power not only increases efficiency, but also consumer well-being—and is an important "supply side" measure.

(One of the aspects of China's march to a market economy is that lobbying—sometimes, in other forms—has appeared within China. Anti-trust laws were originally designed to limit both the political and economic consequences of concentrations of economic power. While China's political system is markedly different, concentrations of economic power can still have worrisome political and economic consequences.)

Other regulatory measures can have important supply side effects. If the government could ensure the quality of food (milk) and products, it would increase the demand, with a corresponding increase in the supply from *good* producers. It is not excessive regulation that is preventing an increase in supply; is the absence of adequate regulation that provides consumer assurance of the quality and safety of the product. Later in this note, we will discuss how better financial sector regulations can increase the supply of finance to small and medium sized enterprises, with significant benefits for the supply side.

Structural Transformation

China's move from an export driven economy to one which is driven by domestic demand, from a manufacturing economy to a service sector economy, from a rural to an urban economy, from the old economy to the innovation economy entails a massive structural transformation. The government will have to play an important role too in these structural transformations. Markets do not manage such transformations well on their own. Moreover, two of the key service sectors which will be important in China's future are education and health. Long term growth as well as equality of opportunity require that the government play a central role in both of these sectors. America's private health care system is inefficient, and delivers poorer and more inequitable outcomes than do Europe's public systems; and France's more equalitarian system has been performing better than UK's two tier system. A two tier system with a weak public tier will be especially problematic.

The Financial Sector

A successful market economy requires a well-functioning financial sector. The large structural transformations described above require substantial finance. Unfortunately, Western financial systems have excelled at market manipulation, exploitation, and excessive risk taking. Most of the recent reforms have focused on preventing it from imposing harm on the rest of society. That is critical, but what is really important is to make sure that the financial sector does what it is supposed to, most importantly providing credit to new enterprises and to allow the expansion of old, and especially to provide credit to SMEs, why typically are starved of finance. Thus financial regulatory reform should be seen as a critical part of a supply-side oriented policy.

At this stage of China's development and at this juncture in an unstable global economy, deregulation and further capital and financial market liberalization would be a big mistake (and certainly should not be a high priority), though to be sure there is scope for further fine-tuning the regulatory system. The focus should be not so much on internationalization of the RMB—though that inevitably will follow, given China's increasing role in the global economy—or on the further development of capital markets, but on creating banks and other financial institutions designed to provide finance to SMEs (Small and Medium Sized Enterprises). These will increase equality and equality of opportunity, as well as support faster, more stable, and more sustained growth.

The Innovation Economy

Too many Western economies looked too much to the financial sector as the source of their economic growth. As we have noted, the deregulated financial sector produced greater inequality, greater instability, and even lower growth.

By contrast, China has rightly emphasized the importance of moving to an innovation economy and what I refer to as a *learning society*. [13] I believe that China still has the potential for very strong economic growth. There is still a very large gap in productivity between the advanced countries and China, derived more from a gap in knowledge than a gap in capital. China has learned how to learn, and so, with appropriate policies, can make great strides in closing that gap. Doing that could sustain growth at a rapid rate for years to come.

Again, government will be critical in providing not just the basic research but much of the applied research necessary for China to close the knowledge gap between it and the more advanced countries. Even in the US, the most important innovations have come from government funded research, not from the private sector—from the advances that led to the computer to the internet.[14] Intellectual Property Rights have to be carefully defined; otherwise they could actually impede innovation, and resources will

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[13] See J. E. Stiglitz and B. Greenwald, *Creating a Learning Society: A New Approach to Growth, Development, and Social Progress,* Columbia University Press, May 2014. Reader's Edition published June 2014 and paperback, October 2015.

[14] The role of government as a source of innovation around the world, including the US, has been emphasized in the recent work of Mariana Mazzucuto. See Mazzucato, M., The Entrepreneurial State: debunking public vs. private sector myths, Anthem, June 2013.

be diverted away from research to litigation.[15] There is a growing consensus among academics that that has been happening in the US. Part of transforming the financial sector to serve the economy, and away from speculative activity, is ensuring an adequate supply of venture capital finance. The education system has to similarly be transformed to support innovation.

The Role of Government

Many of the key challenges facing China today require active government policies—including problems posed by the environment, inequality, and financial instability. The private sector created many of these problems; it cannot, on its own, resolve them. In the United States, we have finally come to understand how the rules of the American economy, our legal and institutional arrangements, have led to the enormous increase in inequality accompanied by the slowdown of economic growth; we now understand, for instance, how financial market deregulation has contributed simultaneously to short termism, inhibiting the ability to make the long term investments necessary for sustained growth, and to inequality.[16] The supply side "reforms" undertaken in the US beginning in the late 70's until the global financial crisis turned out to hurt the economy and society in multiple ways. Growth slowed, government and trade deficits increased, and inequality increased. Instead of having the expected supply responses, both savings and labor force participation decreased, reaching levels not seen for decades. Indeed, some of these supply side measures are directly responsible for the economic crisis confronting the US and the world in 2008.[17]

The key issue is thus not the *size* of the government, but what it does and how it does it. As China's economy has grown and become more complex, indirect instruments, like tax and regulatory policies, become more important. Urbanization makes urban planning critical.

Concluding Comments

In this note, I have been able to touch upon only a few of the key challenges facing China's economy today. There are some I have mentioned too briefly: the need to restructure the economy to address climate change and to reverse the high level of inequality. There are still others I have not discussed at all: Restructuring public finances, including creating a new basis for finance for local government; having a well-developed strategy to respond to crises, which regrettably have become all too frequent;

[15] There is an extensive literature of the adverse effects on innovation of intellectual property regimes, and especially so if they are not well designed. See, e.g. Stiglitz, *Making Globalization Work,* Stiglitz *et al Rewriting the Rules,* and G. Dosi and J. E. Stiglitz, "The Role of Intellectual Property Rights in the Development Process, with Some Lessons from Developed Countries: An Introduction," in *Intellectual Property Rights: Legal and Economic Challenges for Development*, Mario Cimoli, Giovanni Dosi, Keith E. Maskus, Ruth L. Okediji, Jerome H. Reichman, and Joseph E. Stiglitz (eds.), Oxford, UK and New York: Oxford University Press, pp. 1-53 and the references cited there.

[16] See J. E. Stiglitz *et al,* Rewriting the Rules, *op. cit.*

[17] For a greater elaboration of this point, see J. E. Stiglitz, *Freefall: America, Free Markets, and the Sinking of the World Economy,* WW Norton, January 2010.

and creating the legal and institutional infrastructure for the next stage of China's development. I had addressed these more extensively elsewhere[18].

We have explained that there needs to be a balance between supply side and demand side measures. Poorly designed supply side measures in conjunction with an absence of adequate demand side measures will exacerbate the lack of demand and lead to slower growth, more inequality, and more unemployment. Well-designed demand side measures can have positive supply side effects. We have distinguished between supply side measures that are likely to work and those that aren't; and we have identified a list of demand side measures that will have positive supply side benefits.

As China embarks on its 13th Five Year Plan, it is important that it remembers that economic growth is not an end in itself, but a means to an end, to the betterment of the well-being of *all* of China's people. One should never forget that. Each of the reforms that are currently being discussed within China should be evaluated in these terms.

China has been remarkably successful in increasing the standards of living of the Chinese people over the last three and a half decades. The 13th Five Year Plan should be a blue print that ensures that this continues going forward.

[18] Note on "The Next Stage of China's Economic Strategy - with a Focus on 13th Five-Year Plan".