

# China's Structural Reform Policy

*This time is it for real?*

BY CHI LO

**B**eing the biggest saving nation in the world, China is part of the solution to the global economic imbalances that delivered the subprime crisis. In the post-crisis era, the world is watching China do its part in rebalancing its economy from relying on export and investment growth momentum to creating a bigger domestic sector. There are many skeptics doubting China's resolve and ability to deliver such an economic restructuring effort. In my view, the upcoming housing reform in China may likely be a catalyst for structuring rebalancing because things are different this time.

For the first time in many years, there is incentive on both the political and economic fronts to push China toward genuine housing reform. This was not the case in the previous housing reform efforts. The drive to build more public housing will ease social pressure, keep fixed asset investment growing, and offset a slowdown in private housing development. More crucially, acceleration in public housing development will help speed up urbanization and create a snowball effect on job and income growth and wealth accumulation. This is extremely positive for consumption and economic rebalancing.

The rebalancing process will certainly not be smooth. But the force of incentive compatibility to ensure delivery will also be strong. So the Chinese authorities will likely act more decisively. Their effort deserves the benefit of the doubt this time around.

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THE INTERNATIONAL  
ECONOMY

THE MAGAZINE OF  
INTERNATIONAL ECONOMIC POLICY

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### A TOOL FOR STRUCTURAL REFORM

For thirty years, China's economic reform has focused on boosting income growth and making the economic "pie" bigger. However, it has failed to distribute wealth towards the Pareto-optimal state. This means much more can be done to reallocate the pie to make everyone happier and sustain growth at the same time. By lifting millions out of poverty from a very low base of economic development, China has only done the easy part of macroeconomic reform. Now comes the hard part. It will have to implement often painful structural reforms to sustain long-term growth and reduce social tension. Public housing programs will be a key tool to do the redistribution job as part of the economic restructuring process.

Since China's housing reform started in 1998, there have been many failed promises to deliver affordable housing to the public. The reform implemented in the late 1990s shifted most of China's home construction efforts to commercial property development. As a result, the share of commercial residential buildings to total residential buildings completed had soared from about 30 percent in 1998 to over 70 percent in 2008. However, the share of economic (that is, affordable public) housing had fallen from over 20 percent to just 5 percent during the same period. On the back of continued income growth and wealth accumulation, this means that while households' living standards have improved, the provision of basic shelter needs of general households has not caught up.

The government's stringent controls on land supply for property development to protect farmland, hence the agricultural sector, have aggravated the supply problem of new homes. Beijing insists on keeping a minimum of 1,200 billion square kilometers of farmland to secure agricultural supply. However, this policy restricts land supply to homebuilders and creates a serious housing supply problem in the cities. According to the official data, between 1999 and 2007, hous-

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—C. Lo

ing supply growth had consistently fallen short of the increase in urban households. The problem has only eased recently as Beijing wakes up to the problem and tries to encourage more economic housing construction.

Nevertheless, after all those failed promises in the past to provide better and affordable housing, this time around Beijing is more likely to deliver some real housing reform as part of the structural program to re-engineer long-term growth sustainability. The difference this time lies in incentive compatibility both on the political and economic fronts, which did not exist before.

### POLITICAL INCENTIVE COMPATIBILITY

Housing reform since 1998 has created a deep divide in the society between the "haves" and "have-nots" in terms of property ownership. This in turn has led to a rise in social inequality and tension, which has finally caught Beijing's attention. This social pressure coincides with a turning point in China's political cycle. By the second half of 2012 and the first quarter of 2013, both the local and central governments will go through a major leadership change, as required by law after their respective five-year and ten-year terms are up.

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final two-and-a-half-year office terms. They have achieved strong results in terms of macroeconomic progress, with China's GDP growing at double-digit rates every year since they took office in 2003. Their new mandate is to build a harmonious society by reallocating wealth to reduce the income inequality gap. One key tool to achieve this is to stem ongoing property speculation and provide more affordable housing.

Hence, under their new mandate there is now a strong political incentive from the senior leaders to carry out housing reform by building more public housing. At the same time, local officials seeking promotions to the central government will also have an incentive to speed up their public housing programs as Hu and Wen's terms move towards their close as a way to show they are capable of being China's new leaders.

Meanwhile, Beijing's judgment of local officials' performance is changing. In the past, GDP growth was the key performance indicator that Beijing used to measure local performance and as a basis for promotion. But after years of rapid growth, those officials who can make progress in delivering an harmonious society will gain national reputation and score high political points under Hu and Wan's new mandates. Public housing will be a key area where they can make breakthrough performances. Other areas include education, healthcare, and pensions.

In a nutshell, for the first time in many years, the central government's political incentive to make the public housing program a success is in sync with that of the local governments. This political incentive compatibility makes it more likely this time around that there will be some genuine

housing reform in China to aid economic restructuring in the coming years.

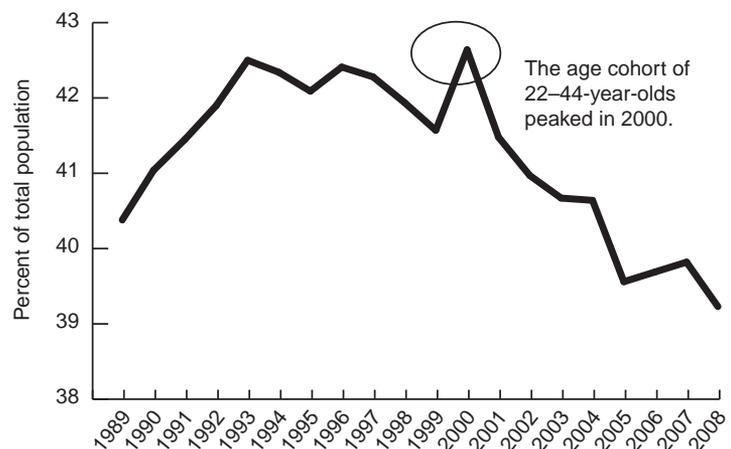
#### **ECONOMIC INCENTIVE COMPATIBILITY**

In the past, when GDP growth dominated policy priorities, local governments preferred to use all their funding on investment projects to boost economic output. They had no incentive for providing public housing as they relied heavily on land sales for funding industrial projects. However, all this is going to change as more local governments will become commercially motivated in pushing for public housing projects in the coming years to facilitate their economic interest.

In other words, the economic incentive of the local governments is aligning with their incentive for building more public housing. Thanks belong to China's shrinking labor force, which is creating labor shortages on the back of persistent strong GDP growth. Due to its one-child policy, China's population is aging rapidly, with the old-age population cohort (65 years old and above) rising to 10 percent of the population in 2009 from 5 percent in the mid-1980s. On the other hand, the young cohort (age 0–14 years old) has fallen to 17 percent of the population from almost 30 percent in the same period. All this suggests mounting labor shortage pressure in the coming decades.

China is already facing a shrinking labor force for manufacturing and construction. These sectors typically hire workers below age 45, but the age cohort of 20–44-year-olds already peaked in 2000. Massive migration from the rural areas to urban centers in the past decade helped ease the

**China's working age population has been shrinking**



Source: CEIC

labor shrinkage problem. However, this pool of rural surplus labor (or migrant labor) is now beginning to shrink also.

When migrant labor is abundant, the city governments have no incentive to develop affordable housing for them and give them *hu kou* (or household registration) status. Without *hu kou* status, those migrant workers are not entitled to any government benefits, such as education, housing, medical, welfare, and pensions. They are treated as aliens and exploited in the labor market. So although China has made fast progress in industrialization, its urbanization process is lagging behind simply because those 140 million migrant workers did not really settle down in the cities, largely due to unaffordable housing. They typically stayed in factory dormitories and slums. However, with a shrinking young working population, the balance is being tipped. Young workers are now demanding higher pay and better working conditions and accommodation. They prefer to work in cities where they can afford small public housing homes and get *hu kou* status.

Hence, to attract young workers, city and municipal governments now have a strong incentive to provide low-cost public housing. Further, with the improvement in infrastructure in the inner parts of China and surging property prices in the coastal areas, it makes economic sense for many local governments to provide public housing to attract migrant workers or even university graduates in order to induce industrial relocation from the expensive coastal areas. For the central government, this east-west investment migration process is consistent with its macro goal of reallocating investment resources and income growth towards the inland. Cities that are most aggressive in attracting industrial relocation are likely to be the most aggressive in providing public housing.

### THE BOTTOM LINES

Incentive divergence between the central and local governments and between economic and social aspects made the previous housing reform efforts ineffective. This is partly reflected by the fact that the pace of urbanization in China has lagged significantly behind the pace of its industrialization. However, in the coming years, incentives are converging on both the political and economic fronts to create genuine efforts for speeding up public housing development as a tool for rebalancing the economy in the coming years. Housing supply rose faster than the creation of urban households for the first time in 2008, suggesting that the government might have finally woken up to the need to address the economic and social distortions stemming from the shortage of affordable housing.

The expected large public housing programs will act to uphold fixed-asset investment growth by offsetting the decline in private housing investment. This should help sus-

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tain GDP growth. The building of mass housing will help sustain demand for building materials, such as steel, cement, copper, and commodities in general over the medium term as the Chinese public housing development programs are expected to last for more than just a couple of years.

Increases in public housing will also facilitate or speed up the urbanization process which, in turn, will become a force for job and income growth and wealth accumulation. From a structural perspective, this will not only ease social tension by spreading industrialization inland and thus help reduce income inequality, but it will also raise the consumption power of the whole population. Currently, the greatest purchasing power rests in the large urban cities on the eastern seaboard, with per capita income over US\$6,000 per year. Empirical evidence shows that consumption would rise exponentially once per capita income surpasses this \$6,000 threshold. Public housing development has the potential to spread income and purchasing power inland, supporting the economic rebalancing effort that the whole world is watching and expecting China to deliver.

Due to incentive compatibility, China may well be at the starting point of a major economic restructuring process that will help address the world's economic imbalance problem and help improve the global economy's health down the road. It is worth giving the Middle Kingdom the benefit of the doubt this time around. The other part of the crisis solution rests in the western world's, notably the United States's, restructuring to become a world saver instead of debtor. But that is another story better left to the other experts. ◆