

**Notes for China Task Force Meeting**  
**“Institutional Design for China’s Evolving Market Economy”**  
**--- on the Broad Issue of Regulation**

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## **Session I. Introduction, Discussion of the Agenda, Overview of Issues**

Main Speakers: Joseph Stiglitz; David Kennedy

### **1. Joseph Stiglitz: Introduction of IPD, China Task Force, and the Agenda**

There are different economic models. Those models are always flawed, and there are always trade-offs in any economic policy. Being a network of economists, political scientists, practitioners from all over the world, IPD is intended to provide alternative ideas to policy makers in developing countries. To pursue this objective, we have four types of programs: Task Forces, Country Dialogues, Journalist training programs, and research programs.

China Task Force explores some ideas with hope that these ideas would have some impact on China's economic policies. China is in the 30<sup>th</sup> year of economic reform and the present time is a critical stage for China in its transition to a market economy with "Chinese characteristics". So there are discussions on how to establish the institutional infrastructure of a market economy in China, like anti-trust laws, property laws, etc. The main idea behind this is that it is a process of evolution. The Chinese people are aware that decisions made today will have big impacts on where China will be going in 25 years. From an intellectual viewpoint – there are interesting ideas on the interface of law and economics underlying these discussions. The Chicago School of Law and Economics is a set of ideas that are very popular in China. This paradigm was very influential for a long time although its intellectual foundations are very weak, but it has been rejected by the academia. Many policy makers have been adopting the old version of ideas flowing around. In fact, the version of market economy the U.S. tries to sell to China and other developing countries is totally different from the version practiced in the US. The market economy that is actually practiced in the US, although imperfect, would work. But the idea of market economy sold to developing countries wouldn't work if adopted and is causing problems in places where it was pushed. It's time to open up discussions on what kind of policy frameworks would be appropriate for china.

The first several meetings focused on issues of property rights. At the last meeting, there were discussions of where we should go from there, and it was decided that there should be discussions on regulations, and this is what this meeting will focus on. The organization of discussions is as follows.

- (1) David will briefly discuss the themes from last meeting on property rights and how they relate to the discussion of regulation.
- (2) I will present the general theory of regulation from an economist perspective, and David will discuss it from a legal perspective.
- (3) Then we will discuss particular regulatory issues to see how these concepts play out as we think about particular contexts or how ideas get manifested as people try to solve problems in particular areas. I think

this is a good time to discuss regulation since there is now consensus that regulations have failed, as shown by the financial crisis in U.S., the falling of poorly made buildings in earthquake in Sichuan, China. In the U.S., there's a total rethinking of regulations in light of recent financial problems.

(4) Tomorrow afternoon, we will discuss issues of inequality, macroeconomic policies, some property rights issues left over from last time.

(5) The last session will discuss next steps, where to go from here, and how to structure project going forward.

## **2. David Kennedy: Main Ideas from Previous China Task Force Meetings**

Let's go back to discuss regulation from the legal point of view. Economists discuss whether or not to do it or to do it in certain ways, and come up with arguments on the kinds of regulation one would propose. From the legal view this is an odd starting point. The discussions at previous meetings tried to unpack pieces of the legal system that appear prior to regulation, but that also appear to be tools of regulation. There are three elements here.

### **(1) Idea of institutions**

Economists' idea is that institutions somehow exist and we want good ones. It is assumed that once good institutions exist then we can do the regulation. The main theme from the previous meeting is to go inside this assumption and figure out whether there are choices in institutional structure and whether they have regulatory impacts. For example, in corporate finance, the range of relationship between different entities that could be structured readily, different risks exposures of managers and investors, etc. There are alternative policy choices that require economic analysis. Discussions on those issues open up the concept of "good institutions" for regulation we hope to discuss today.

### **(2) Idea of process.**

Economists have this idea that we need good legal process and whatever the regulations are figured out they will be more effective via this process. From the legal point of view, process of enforcement is not mechanical, but rather a complex set of particular institutions could be set up in a wide variety of ways. There is a range of levers people are trying to use, such as what states do, how strictly to enforce, how much discretion, etc. There exist dozens of opportunities to soften or harden by the process when institutions are implemented. To sum up, we're at regulation before we get to regulation.

### **(3)The issue of private law itself**

It's traditionally understood that Private Law is the law that governs relationship between individuals and institutions horizontally, as opposed to public law which governs relationships vertically between the state and individuals. Sometimes Private Law and Public Law are understood to be distinct. Last time we discussed "property rights" and this time we will focus on "regulation" as if the distinction between the



two is clear. But over last century as more complex structures are built, the state plays a bigger and bigger role and even private legal order is in some sense a regulatory order. This goes back to the theme that we're already at regulation before we get to regulation.

How does this argument bear out in the context of property rights issue? Economists come up with new ideas of what we need to do, often coming with preset notions on what law is and what it's capable of doing. Chicago school of law and economics certainly did. Lawyers see this as unrealistic in the expectations of what law could do and narrow in the range of regulatory possibilities that law can provide. On the one hand, it is unrealistic because it thinks that we can transform a society's economic structure through legislation. But the law as it appears in books and the law in action are not the same. Thus legal reform may not work out as expected. On the other hand, it is limited because it believes that there was a specific form of law that was correct and proper, i.e. formalized and strictly enforced property rights that was a necessary baseline for economic and market efficiency. But this belief narrows the scope that law can do.

Here are some core ideas about property rights which are familiar to lawyers.

(a) Commonplace observation is that private law gives someone exclusive dominion over an object. But granting sovereign power to one person also places that person in specific relationship with other people who might want to use the object. Allocation of property rights affects the ability of various people to bargain over things, e.g. wages. If entitlements are redistributed, bargaining power of either party and thus prices could be changed. This means that private law can be arranged in more than one way. It's easy to imagine that there's a basic form of property rights absolutely enforced by the state. But this is not the key form that property law has taken.

(b) With private law, rights can be transformed into tradable good at some point. The question is at what price. What can you get for trespass? How can you get that? How do you value it? These discussions will change relationship between trespasser and owner. People have different ideas about trespasser and owner: adverse possession, i.e. if the owner does not use land productively, others can use it and get title; property duties, i.e. land should be available for use of others; variety of interpretations on what it means to be owners considering interests of other parties; etc.

Property is a "bundle of rights". There may be competing interests of adjacent owners. The owner of property does not own absolute right to do anything. Exclusive use of one property by the owner could have impact on other property owners' use of their property. It's more obvious if we look at intellectual property rights. In many cases the property system has to make a choice between prospective rights. Sometimes judges can use economic theory to organize private law arrangements that could enhance efficiency. Legal professionals are very interested in those smart economic ideas but they often run into problems in practice. For instance, it's hard to distinguish prices that are distorted by regulations and prices that are bargained within shadows of regulations since prices are set in the first place in the institutional background. Therefore, we need to look more explicitly at specific areas of regulations to think through about what kind of choices should be made.

### **3. Discussions**

#### **Joseph Stiglitz:**

There are such ideas in classic economics that you can separate efficiency from distribution affects. But modern economic theory clearly rejects this classical dichotomy. You can not separate efficiency form distribution, the attempt to re-distribute would itself cause distortions. There's also no way to really make sure that some of the compensations you think could come would really occur.

The second idea is that regulation is associated with public side. But on private side there're all kinds of regulations. For example, fire insurance contract says you have to have sprinklers and if fire happens we'll compensate you. It is the same requirement as public regulations (you have to have sprinklers). In a mortgage contract, the seller says you won't be given the mortgage unless you have fire insurance. One can go back further and further in this web of regulations that are set by private parties. But in what way are they different from public regulations? According to Chicago economists, there is no need to worry about private regulations because they are voluntary interactions and the outcome will be welfare-enhancing; but we have to worry when regulations are implemented by the government and non-voluntary. They think all we need to do on the public side is to enforce whatever the private sector agrees to. But, as David Kennedy said, we can't do that because there may be a set of private contracts that are not simultaneously consistent. So people can't make private agreements without a set of rules that step in when those agreements are in conflict. In other words, private agreements are made within the shadow of public law.

Two themes came from Property Law discussions:

(1). One problem of China is being a big country with federalist governments. It is not just that central government makes decisions and other local governments obey. Who has right to regulate? Who has right to define Property Rights? These are public decisions, but they affect the way property rights are assigned which can percolate down to the market economy.

(2) Inequality is going to be a central part of discussions in China. In every level of discourse there are problems of distribution, distributions of wealth, economic rights, power, and income. This perspective is hidden behind debates on appropriate institutions or legal framework. So, what are the appropriate institutions for China? What is the nature of equality in Chinese society?

#### **Stephany Griffith-Jones:**

I want to make two points. (1) It's disturbing that in the issue of distribution, the traditional tool has always been taxation. (2) The private vs. public law discussion so far hasn't mentioned two issues in design and implementation of public law. One issue is that private aspect has been growing dramatically; the other is regulatory capture, i.e. public regulations are often captured by those who are supposed to be regulated, especially in the financial sector.

#### **Francis Snyder:**

I have two questions. (1) In the four elements, legal ideas, economic theory, political science, and ideology in the society, have changes in economic theory affected those other aspects? (2) Who defines the public interest? How is it defined? What does public interest mean when the idea that state decides public interest is abandoned?

**Joseph Stiglitz:**

(1) New ideas in economic theory have had less impact than they should have. There are some answers to issues that David discussed. Every dispute relates to the economics of information. Judges have very imperfect information, so there's no simple formula that can be adopted. Sometimes there are prior beliefs that can't be articulated, but judges have to make decisions on the intent of public interest. That kind of precision of Chicago school view of law depends on perfect information which is impossible in practice. So changes in economic theory changed the perception of law and economics.

(2) The traditional view of public interest is that we can define public interest by efficiency. We can first have efficiency and then discuss how to distribute income to society efficiently (the classical dichotomy). This is too simple. In reality, we can not separate efficiency from distribution. We need social justice and distributional concerns to define public interest.

**Athar Hussain**

The question of who determines public interest is troublesome. Using Brian Barry's discussion, public interest is determined by the kind of argument you use. There's ambiguity since people have various motives and they might make various kinds of arguments.

**Joseph Stiglitz:**

No one ever says they do something for private reasons, everyone says they're doing this for public interest. But skeptics say that's just the language which people use to debate these things and that it's all private interests. But some say this isn't true, some people are less selfish than others.

**Jun Fu:**

I would like to answer Francis's question. In the US, institutions are more refined and differences on the margin are difficult to define. If we look at China in the past 10 years, economics has made a huge difference on the concept of public interest. 10 years ago Chinese people judge public interest from personal experience, but now in long term interests. In short term some people may make sacrifice, but in the long run public interest come. One example is the entry into WTO.

**Francis Snyder:**

People may agree on procedures if they can't agree on outcomes. Then discussions on procedures become very important because that's where the distribution issues are crystallized and hidden.

**David Kennedy:**

What entities get to turn on the switch of the enforcement machinery?

**Francis Snyder:**

We can look at china's Cooperation Law.

**Joseph Stiglitz:**

Distribution gets submerged in political processes because it's not understood by one party and the other manipulates this. One example is the Ethanol debate. Ethanol was subsidized for a long time since Mid-1990s. At that time ethanol was linked to one company (90% market share) who wanted to keep ethanol subsidy. At the time, there is almost no environmental benefit, but the company has persuaded corn farmers in Iowa that this is good for them so corn farmers voted for their interests. Public discourse was that doing so is good for environment. Politicians listened to these corn farmers. But all the benefits went to the company and farmers didn't get much benefit because there was no price rise in corn since the quantity used for ethanol production was low and so it didn't affect the corn market. This has distributive consequences, but it's less transparent than other things.

## Session II. Principles of Regulation

Main speaker: Joseph E. Stiglitz

### 1. Joseph E. Stiglitz: Principles of Regulation

This paper was originally written for the Tobin Project's conference held in this February, which was motivated by a major change in the climate for regulation in the U.S.. There is a growing consensus: there was a need for more government regulation and the view advocating deregulation has come to an end. It is a good opportunity to redesign regulations and to learn lessons. One of the key lessons is that writing regulations is not enough and we need to think about regulatory capture, especially who implement regulations.

#### (1) The Need for Government Intervention

The general theory of regulation begins with a simple question: Why is government intervention needed? There are at least three strands of analysis underlying the demand for regulation.

##### (a) Conventional market failures

Markets, by themselves, don't lead to efficient outcomes because assumptions under which markets are efficient are not satisfied in practice. Regulations can thus play an important role in addressing market failures. One example is food safety. The genesis of regulation in this area came from private sector in the US. In early 20<sup>th</sup> century, Upton Sinclair's novel *The Jungle* depicted the terrible sanitary conditions in America's stock yards, no one wanted to eat meat. Meat industry asked for government food safety regulation to restore confidence. Private sector recognized that self-regulation was not convincing. But this is exactly what financial sector has done. Companies have paid accounting and rating agencies to say they're safe for investment. It's perhaps no surprise that the rating agencies gave AAA rating to highly risky financial products.

##### (b) Market irrationality

A second justification for regulation focuses on market irrationality. Economists typically assume that individuals are rational and irrationality as an argument for regulation has been driven out of realm of public policymaking. But individuals may not be rational and may deviate from rationality in systematic ways. There's no way you can reconcile what happened in financial market with rational behavior. One concern is why we believe the government is more rational than the market? Part of the answer is that the government doesn't have as much incentives to be irrational than the market. The government has the obligation to keep economy from collapsing and so they have different loss function.

##### (c) Distributive Justice

The third rationale for government intervention is distributive justice. The strongest argument for a

market economy is that it's efficient but no one says it produces distributive outcomes that are socially just. Regulations may be an important instrument for achieving distributive objectives.

## **(2) Regulations vs. Taxes**

If there is to be government intervention, why does it take the form of regulations instead of using "market-based" interventions, i.e. taxes and subsidies?

### **(a) Imperfect information and incomplete contracting**

Taxes are usually linear, e.g. the more you pollute, the more you pay. Regulation can be seen as a non-linear tax system, e.g. you pay zero up to some level of pollution; beyond that level, you may be put into jail. In the presence of imperfect information and incomplete contracting, optimal incentive schemes typically are highly non-linear and may even impose constraints. Thus it is better to have regulations.

### **(b) Taxes have large redistributive effects**

Tax interventions may have large redistributive effects, which can be mitigated by regulations. But regulations can sometimes hide distributive effects. For instance, with inelastic supply curve, to get people to change behaviors, you need to impose very high tax on prices, which will generate high distributive consequences. You may say we can compensate people who are injured, but in fact it is very difficult to figure out how much to compensate.

## **(3) Instruments of Regulations**

Regulation takes a number of forms and regulatory frame has changed great deal in past years. We used to begin at the bottom. If something you don't like, say you can't do it. But in many areas, the focus of regulations is on things that are easy to implement and are less obtrusive.

### **(a) Disclosure**

In many areas the least invasive measure is information disclosure. Market forces do not necessarily lead to full disclosure of information, so there is a good rationale for disclosure requirements. Markets cannot function well with distorted and imperfect information; hence, requirements that lead to improved information may lead to better resource allocations. But it should be clear that in many areas disclosure itself does not fully address the market failures discussed earlier. This is partly because market participants do not know how to process fully the information disclosed. Part of the reason is that even if market participants know what firms are doing, firms may still not behave appropriately. World Bank's book "Greening Industry" believes that all we need to do in order to clean environment is to require every factory to disclose how much it was polluting and then social pressure would come to bear and shame would make it stop polluting. But this is largely imaginative. Some firms brought up with dirty minds feel no shame for pollution. If this continues to exist, good firms can't compete with dirty people and may become dirty.

### **(b) Behavior restrictions**

The most direct restrictions are proscriptions on behavior, such as, banks are not allowed to engage in insider lending. Regulation often focuses not so much on behaviors as on factors that might affect behaviors. A critical issue is the specificity of the restrictions. The economy is always changing, especially so in the financial sector. Regulators may only be able to set a broad target with much muted punishments so as to affect the incentive structures for market participants.

There may be different ways to restrict behaviors. Tort laws deal with problems *ex post* rather than *ex ante*. Consider the example of speed bumps, i.e. one can't drive faster than certain rates. One way to regulate is "you can not drive over 50 miles per hour, otherwise you will be taken to court". Or, you can do it but if you have an accident you will be punished seriously. In legal framework these words are often vaguely defined, but get defined over time. However, if these regulations are made *ex ante* these words are better defined.

#### (c) Ownership restrictions

Sometimes we go beyond restricting actions, we restrict ownerships. For example, we not only restrict anti-competitive actions, we also break up monopolies because we believe that it is impossible to stop them from acting in an anti-competitive way. Many governments restrict ownership of certain key assets to citizens of their country. Proponents of ownership restrictions believe that there are inevitable conflicts in certain areas between private owners' interests and public interests. Right now there is a big debate over Sovereign Wealth funds. The concern is that the government might have incentives to use assets in ways that are not consistent with public interests. From yesterday's dinner discussion, Chinese firms are more socially responsible than American firms.

#### (d) Mandates of behavior

Mandates have become more popular since they enable the accomplishment of public purposes without the expenditure of budgetary money. But they are often a hidden form of taxation. Yet, some mandates may be viewed as efficient ways to address complex social problems involving externalities, like restriction on land use in zoning.

### **(4) Debates over regulatory takings**

All regulations affect property values. Then should the government compensate those who are adversely changed by the passage of regulations? Providing compensation for "regulatory takings" in a world with budgetary constraints greatly refrains regulation and that is the intent of many in the regulatory takings movement.

Let's go back to the value of property rights. One possibility is that private sector has full property rights and the government cannot just seize somebody else's property. Another possibility is that the government can take away all the useful rights of property and the value of the property goes to zero. But there are hundreds of possibilities in between these lines. For instance, the U.S. Endangered Species Act can be viewed as requiring property owners to provide a public good. When owls alight on trees you own, you can't cut them down. This act represented a change in property rights. Today, people say that if this

happens, the owner should be compensated. But the owner bought the property knowing that the Endangered Species Act was already in place. If the government will compensate the owner, that's giving them property rights. The message in this example is that history matters in a great deal.

Anti-regulatory movement proponents recognize that there are good public interest concerns in regulations, but they think that the government has to pay for it. If the government doesn't have the money because of budgetary constraints, the regulations cannot be implemented. Courts have consistently rejected the view that regulatory takings require compensation and so have legislatures. A possible important exception is Chapter 11 of NAFTA, a trilateral agreement between U.S., Canada, and Mexico. In that agreement, bold print says "this is to stop expropriation" about basic property rights, but fine print says "there's a regulatory-taking provision". David's public vs. private point is interesting because private firms are now allowed to sue the state that has done regulations to change distribution of income (and property rights).

### **(5) Regulatory Processes and Democratic Accountability**

Typically, in the case of regulations, there is some delegation, i.e. the legislature delegates authority to a regulatory agency which is assumed to have greater expertise in addressing the complex technical issues. But this regulatory process could result in regulatory capture. Experts tend to be linked to industries where they come from, thus there is usually bias in delegation process itself.

A typical example is central bank, where recent doctrines are that independent central banks lead to better performance. But the evidence is less than compelling. Essentially the central bank is delegated the authority to regulate and implement monetary policies. The question is in whose interest? Greenspan says he was doing it for national interests, but he's actually doing it more for financial markets' interest. U.S. had good central bankers, like Paul Volcker, who squeezed inflation out of the economy but was fired by Reagan. Paul believed markets don't always work perfectly and so there was a role for regulations. He said that the central bank was created through democratic processes and so it has to be accountable. Reagan appointed Greenspan, a regulator who did not regulate. And today we have to live with the consequences of independence of central bank with no accountability. In the UK, the government sets inflation targets and central bank has independence in how to implement the targets. Sweden has independent central bank but always has a representative from labor union present. So model of economy was built into political infrastructure.

### **(6) Government Failure**

We noted that the main rationale for regulation is market failures. But Chicago school argues that markets may be imperfect but the alternative is worse.

However, government failure is not inevitable, these are matters of degree. All institutions are created by humans so they are fallible, but some are better than others. I believe that the government has more incentives to do well than others. So it is not inevitable that there will be government failure. A broad



notion is that the government checks on private sectors and vice versa. Some regulatory processes are more subject to failures, and part of the art in designing regulatory regimes is to identify those that are less likely to be captured or abused. One way to reduce the scope of regulatory capture is to have multiple regulators, e.g. regulators of banks and security markets.

Furthermore, as long as sufficient transparency and competition, there are corrective processes. Governments that fail will be replaced; they lose credibility and legitimacy.

Enforcement of regulations is important and it is impossible to anticipate every situation. IMF argues that their ideas were right but not well-implemented. But maybe the ideas can't be implemented by humans. If this is the case then there's a design flaw. So a flexible regulation framework is useful. Martin Act is an example. There is a multiple regulatory structure in the financial market in the U.S.. The SEC was captured and failed to take appropriate actions in the case of many bad behaviors earlier in the decade, but New York State did using the flexibility of Martin Act. The notion of Martin Act is that if you behave badly, we'll stop you but penalty is relatively low, e.g. fines are relatively low compared to the amount of harm done; but it also says that you can't do it again otherwise you'll be punished more. This was successful in stopping bad behaviors.

## **2. Discussions**

### **Athar Hussain**

There's an automatic presumption that financial regulators are those in the industry. They're more likely to frame financial regulations in particular way, even though they may be perfectly honest people.

### **Joseph E. Stiglitz:**

These experts are embedded within the industry so they adopt the model prevalent in the industry. Even Paul Volcker was prone to this. In some areas, it's easier to get people from outside the industry. Columbia doesn't allow people from financial industry to come on board at the central bank. I won't recommend it, because that means the only other people who can sign on are university professors, but is this a good choice?

### **Ye Qi**

Last week the Chinese government passed some regulation that raised gas prices. The regulation set in such a way that taxi drivers can be compensated because their interests are affected. This goes back to the issue of public interests.

### **Joseph E. Stiglitz:**

This is an interesting question, maybe we will come back to this again. But why not raise taxi price to encourage people to use public buses more? Why didn't government do that?

### **Ye Qi**

The taxi companies are protected by the government. They are afraid that people won't take taxis. These companies have big influence on policymaking.

**Stephany Griffith-Jones:**

At a meeting where half of participants weren't experts, they are politicians, trade unions, etc.. The discussion was of high quality. It does make a difference to have non-experts.

**Liqing Zhang**

In the financial sector, regulations are necessary. But in many cases, when regulators do something it's always very controversial. Like in the U.S., when Federal Reserve System got involved in bailing out some investment bank, some people believed it should not be bailed out because it would encourage more risk-taking in the future. So how to make sure that those regulators will avoid such mistakes?

**Joseph E. Stiglitz:**

We'll come to the financial sector later, but I think this goes back to the part of government failure. There will be mistakes, but there are hidden distributive effects for every regulatory action. People often try to use some language to hide their real motives. When you say 'the bail out' critics may say you shouldn't use this word. What's interesting is that the same language was used by the American government, they said they can't bail out poor Americans because there'll be moral hazard issue. We have the language for debates, but the language sometimes has nothing to do with what's going on.

**David Kennedy:**

There are two issues from last meeting I like to put on table. One is about private rent-seeking. There is path dependency. When some regulatory structure is set, it creates interest groups, which could affect the government's ability to come up with new regulations in the second round. Last year there was a lot of skepticism if that would ever happen in China. We were worried about allocating property rights in a way that they would have impact on the government to make new regulatory moves. The second issue is about regulatory design. Price regulations have distributive effects giving someone the ability to buy certain activities at certain cost, but judge will step in to compensate for the losses.

**Joseph E. Stiglitz:**

The above argument is in favor of court law. Let markets do the cost-benefit analysis, prices are set by market. But the other side of that is, you can't compensate for someone who was killed. The fact that calculations may be right or wrong doesn't matter. In this case, compensation is always inadequate.

**Heping Cao:**

Is regulation a kind of public good? Some regulations look like "club good". Special interests can push "club good" type of regulations. So "club good" type of regulations are oversupplied and "public good" kind of regulations under-supplied.

**Joseph E. Stiglitz:**

Regulation should be a public good.

**Carl Riskin:**

Some important functions can be done by the way of regulation, or may be done on a public service basis, like government rating agencies. Distinction between regulatory and public service would make any sense in a case like that?

**Zhong Zhang:**

Some regulations can be bad. Licensing is very popular, but it has negative consequences, such as restricting market entry, causing rent-seeking, etc. Actually, we have some regulatory tools in the traditional way, like liability rules in corporate laws, etc. Then why don't we use this kind of traditional liability rules in some areas where licensing may be bad?

**Joseph E. Stiglitz:**

In most areas licensing is to restrict market entry but not to ensure quality or legitimacy of market actors. Disclosure can ensure the latter goal.

**David Kennedy:**

There is a whole literature on liability law and licensing. Would liability rules be better than licensing?

**Francesco Saraceno:**

I have two questions. One is about taxes vs. regulations as ways of government intervention. Is it a theoretical or empirical question in the end? Another is about Joe's argument for multiplicity of regulators. On the one hand, having multiple regulators will ensure competition; but on the other hand, many regulators may not be as powerful as one big regulator. How do these things go together?

**James Galbraith:**

Why is there a need to make a case for regulation? Every aspect of life in an advanced and complex society is regulated, except in markets where the quality of products sold is well defined and one can quickly find scope in which firms can operate freely without regulations. Regulations are totally pervasive.

**Joseph E. Stiglitz:**

I agree. In standard economic model with well-defined goods, people know what the goods are. But this is not the case in the real world. This goes back to notion of public good. Regulations are providing public good functions by telling people what are traded on the markets.

I want to make a point that comes up in every area. Economists talk a lot about incentives, which are important. Failure of credit-rating agencies is demonstrable, repeated, and the problems of them were exacerbated by perverse incentives. The incentive structures undermined our confidence in what they were doing. But the main reason they failed was utterly incompetence which has nothing to do with

incentives. Mediocre students go to work in these rating agencies. Would I rely on these student's ratings? Of course not. Why do we think these students will do a good job in this? An important question is how to make the system work better, knowing that these types of people exist.

The case of licensing vs. tort/liability law is an interesting example. Licensing was, in some ways, attempted to work on the first part of instruments by only allowing good people to enter the industry. Like banking regulations, a criminal cannot be a banker. But most licensing is restriction on entry. When I was with the Clinton administration, in most areas we only had disclosure requirements and no licensing, so that we can find them and can hold them into accountability if they do something. In some areas, like capital adequacy regulations, we want to make sure banks have the right incentives to behave appropriately. In the financial crisis, the government stepped in, but the decision-makers are the same and owners' incentives remain unchanged. This is an example where regulations are well-designed but implemented by people who don't know how to use them. We will leave this for discussion on financial sector. About the point raised by Francesco, I think they are parts of the regulatory structure, but it's a question of balancing.

## **Session III. Product Safety and Quality**

Main speaker: Francis Snyder

### **1. Francis Snyder: Regulation of Product Safety and Food Safety in China**

What I'm going to talk about is a work in progress. I'm involved in two ongoing projects. One project is about Toy Safety in China, the other is about food safety regulation in China.

#### **(1) Toy safety project: research questions**

(a) How are the production, distribution, and consumption of toys in China regulated, both the law and in practice? The project is to make several points. The first point is the implication for research method. The second is we intend to cover all phases of the toy chain in China, from the beginning to the end. We would like to make use of a number of disciplines, not just law, but also political science and economics. We also want to take into account international (e.g.WTO), foreign (e.g.Europe and U.S.), and Chinese regulations.

(b) What does this tell us about regulation of the toy sector, the relation between international, foreign, and domestic regulation, the role of law and regulation in China and regulation more generally?

(c) If "market failure" is taken as reason for regulation, what does "market failure" mean in this context? Does it explain the creation/existence of regulation or specific types of regulation?

Only pilot study has been done so far, including carrying out preliminary library research, establishing working contacts with government officials and business organizations so that we can do interviews after Olympics Game, and compiling bibliography in all relevant languages.

#### **(2) Toy Safety Project: Working hypotheses**

(a) The idea that how toy safety is regulated in China cannot be understood by looking at laws alone, or at the implementation of laws alone. We need to take account of global legal pluralism, relations between Chinese regulatory and implementing institutions, market structure, and regional and economic diversity.

(b) Toy safety in China is governed by multiple sites of governance, i.e. locus of decision-making authority to settle disputes. These sites form part of the global legal pluralism.

(c) Regulatory regime suffers from relative lack of structure and transparency. In order to be effective, it requires construction of identifiable and accountable governance networks.

### **(3) Toy Safety Project: Pilot phase plan**

The pilot phase started in March 2008. The research team including members from LSE and PKU has had several meetings so far. A workshop is to be held in Beijing in September. We are also trying to find funding for follow-up research in December. We have 6 or 7 team members working in different areas. These areas of work include:

#### **(a) Global legal pluralism and toy safety**

We try to identify what these laws are, including international law like TBT, regional law like EU law, and national law like Chinese law, etc. We focus on both hard law and soft law and other types of institutions and norms. Some example of soft law are EU-China Consultation Mechanism on Industrial Products (2002) and EU-China Road Map on Safer Toys (2006). We also analyze the interrelations between these different types of institutions.

#### **(b) EU domestic environment standards and toy safety**

How these EU standards and laws are applied to imports from China?

#### **(c) Chinese domestic laws on toy safety in a broad sense**

Domestic laws are not just legally binding measures. The court plays a relatively minor role in most places, in particular in China. So we look at major regulatory bodies and characterize Chinese domestic laws on toy safety, environment laws, and consumer protection laws.

#### **(d) Chinese institutional structure for policy-making and implementation on toy safety**

The institutional structure of Chinese government concerning toy safety is characterized by competition between policy-makers, ministries and similar organizations. A simple way to set up regulatory system is to have different governmental bodies. There is talk of about 20 different bodies being involved.

#### **(e) Regulation of market of toy producer in China**

We do analysis of industrial structure of toy producer market. How are toy producers in China regulated through legal and non-legal means such as codes of conduct, personal relations, relations between central and local governments? Anti-monopoly laws likely have impact on the market.

#### **(f) Regulatory competition among toy-producing provinces in China**

#### **(g) A Case study of Mattel**

There are a number of problems in the toy exports from China to US and EU. Mattel apologized publicly to the Chinese government last year. We want to look at how this works symbolically and for business.

## **2. Discussions:**

**David Kennedy:**

There are examples of soft laws. EU has 25 dialogues with China on different topics. It overlaps with food safety. A dialogue can be legally binding or not, but it has a lot of legal-like element: insistence on the activity based on mutual agreements. The most detailed one is the Safer Toy Road Map, which is designed to bring together administrative agencies, EU businesses, and Chinese businesses, and also bring together mechanisms to solve difficulties in the toy sector before they appear in public eyes.

**Athar Hussain:**

How effective is it that Chinese toys are refused entry to EU or US market regarding improving toy safety?

**Francis Snyder**

There are lots of complaints. According to newspapers source, the government has shut down several thousand factories and also increased inspection. There is a real effect, it seems to be the same as what goes on in the food sector. The government tries to consolidate and make bigger producers, thinking that bigger ones would comply more with standards. But the products going to the domestic market might not comply with standards.

**Joseph E. Stiglitz:**

Can you describe the apology that was given?

**Francis Snyder:**

Yes, I read it in the Chinese newspaper in English. Mattel is a big company with high profile. There are reports that toys from China can't get into EU market. First Mattel did nothing. Then there was report on how many suppliers it had. Mattel published a public apology to the Chinese government, saying that we are sorry for any harm that it has caused to the reputation of Chinese people. Something like that. There was a Canadian guy saying that it's right because it's not the issue of Chinese producers not following standards but a design default. Mattel has claimed it's their own fault.

**Joseph E. Stiglitz:**

Can U.S. reject toys from China under WTO rules or do they have to show more proof? What is the burden of proof? There are constant debates on food safety. Only a few people have died from Mad Cow disease, and so we must accept new standards about cows: if cows can stand up for 5 minutes then they are safe to eat. Does China have to show that the toys are safe, or do importers have to show that toys are unsafe?

**Francis Snyder:**

Under WTO, we can reject things for environment and health reasons, all under TBT agreement.

**Joseph E. Stiglitz:**

But does it come from the US side or the Chinese side? It's a legitimate concern that there be safe toys since we don't want our child to die does not imply that all toys from China are bad. Does the US have to

say that all Chinese toys are safe or only toys with poisoned parts are unsafe or what?  
Do they have to cite particular things?

**Francis Snyder:**

They can send back the toys. EU works together with Chinese government by using a rapid alert system, meaning they try contact the Chinese side if a problem is found and try to solve the problem right away.

**David Kennedy:**

Just figuring out the regulatory network is complicated. What are the GATT rules? But actually in going to the GATT rules you have to go through so many other institutional features that the GATT becomes almost irrelevant. You can use GATT rules but that throw you into negotiation.

**Francis Snyder:**

There are very few cases. That's why focus of this research is on the nexus of institutions related to regulations.

**Roselyn Hsueh:**

Do you have any hypotheses about differences between toy safety and safety regulations in other things? For example, the food safety is being more centralized. What causes that? And why?

**Francis Snyder:**

The food safety regulation is more centralized in the sense that there are fewer domestic agencies. What strikes me is that the responsibilities are very spread out because everyone on the food chain is responsible. The other thing about food safety is that the government is trying to consolidate the industry with policies to get rid of smaller producers that aren't complying regulations at all.

**David Kennedy:**

Another interesting thing is the idea that the mechanism of regulation is not necessarily a rule about the topic, it can be a framework of conversation that leads to adjustment. That is a technique that has nothing to do with setting the standards and whether or not rules and contracts are legally binding.

**Francis Snyder:**

In China most standards are private standards, set by businesses.

**Athar Hussain:**

Coming to the case of the poison dumplings. The failure is not the standards but the inspection routines. Companies observe regulations not simply because there is inspection, but because they follow procedures that are in compliance.

**Joseph E. Stiglitz:**

You referred to regulatory competition across provinces. Can you comment more on that? The image is



that there is such competition to lower the price that the producers look for lowest costs or the least regulatory environment, subject to some notion that they do not want children to die and they lose their business. At some level, importers have an interest in making sure that children don't die.

**Francis Snyder:**

The person who's done the interviews for a month finds that it's not a race to the bottom. Companies are not looking for lowest costs. Price is only one of the elements that they are bargaining about. It could be good connections with local governments, how many inspections every week, things like that. My recollection is that the cost of production is not the main factor. Reputation is very important, especially for pharmaceutical companies.

**Joseph E. Stiglitz:**

This is where agglomeration could be relevant. One argument is that if you are a small guy and you produce a bad toy, you go out of business and open up under another name, so you have no liability. Limited liability is no liability in some sense. So what the government is trying to do is to restructure the ownership to make regulation systems work. Is that part of what's going on?

**Francis Snyder:**

Yes. It's certainly for the international market, and even domestic market, china doesn't want poison toys at home.

**Joseph E. Stiglitz:**

What does this mean for barriers to entry?

**Francis Snyder:**

We always talk about the virtue of competition. Toy sector is very competitive and the government forces more consolidation, which will raise the level of company licensing and product standards. What we will recover is regulation with Chinese characteristics. I'm very skeptical about the market failure justification. Does it make sense in Chinese context in which different ministries compete, local governments also compete, and there is a distinction between central and local governments?

**Athar Hussain:**

There are also strategic behaviors.

**David Kennedy:**

Regarding the question on race to bottom, one study found that after crisis there is a rapid race to the top followed by a slow decline to race to the bottom, then something brings things to the public eyes and another race to the top again. How do you track that overtime? It's a much more complicated sociological model that just race up and race down.

**Ye Qi:**

One observation is that the food safety is more problematic in the domestic market than in the international market. There is difference in order of magnitudes. Also, the enforcement mechanism in China is different. In the international market, the market itself, the consumer, international trade, legal pluralism, etc. all act. But in domestic market, you find none of this work to enforce food safety. Lots of consumers are not so willing to buy. They complain about regulation because the regulation means they have to pay more now. So the way the government regulates domestic market is very different. There is a contrast between the two markets.

## Session IV. Antitrust Regulation

Main Speaker: Jun Fu

### 1. Jun Fu: Recent Development on Anti-trust Regulation in China

This project is to draw lessons from the past 30 years. It has a lot do with the theme about institutional design and regulation if you consider competition as part of regulation. A big question is why some countries richer than others. I came up with a hypothesis which I call  $BM=W$ . Wealth is a function of how you build hierarchy (bureaucracy and how you build horizontal institutions called market.

Assumption: (1) Everyone has 24 hours a day, and decides whether to spend their time productively or non-productively. The challenge is to design institutions and regulatory framework to maximize the productivity and minimize the non-productive activity of each person. (2) The number of individuals is  $N$ , so total wealth  $W$  is  $N$  times each person's wealth.

Then we look at real world. If I rank all countries measured by GDP per capital, you have the top rank, middle rank, and lower rank countries. We start to think of what gave rise to this pattern.

Two key variables are important: market as an institution and rule of laws. These two variables cannot be separated if you have a mature market system. That is the variable  $M$  in the model. The third variable is democracy. In the rise of the wealth of some top countries, the US for instance, the U.S. giving every citizen the right to vote took place in 1920.

In the model,  $B$  is how to select talents. All else equal, if you have a good selection mechanism, then you're ahead of others. Interestingly, China was the first to have selection institutions. China had imperialism with an inter-personal system to select talents, when others tried to place people on hierarchy, people would use connection, friends. But China actually had a history of selecting relatively impersonally. If we measure GDP per capita in China from 700-1200, China was way ahead when talents were allowed to sit on the hierarchy to regulate and design institutions. China matured in Song dynasty. After that, GDP per capita stagnated, while other countries built very elaborate system of check and balance. In the political realm, constitution is really the anti-trust law in the regulatory realm. Then countries also started to build market system. Looking at the world today, if a country builds a sophisticated system of  $B$  and the market, the country will be ahead. Globally human beings have developed from a system of rule by man, to a system of rule of law. At a time the system was first designed, everyone was equal in front of the law, apart from the Emperor. In regulations Joe is talking about experts. In mature market, actually it's the civil servants that regulate markets. They are not doing that in answering to the wishes of political appointees. When I looked at institution, I try to see its causality for efficiency. For lack of good measurements, I look at GDP per capita. GDP per capita in China did not rise in the Qing dynasty, but dropped. In the collapse of the Qing dynasty, there were

complaints about its imperial exam system. Abolishing imperial exam saw dramatic decrease in Chinese GDP relative to rest of the world.

We can draw some lessons from 30 years of reform. If we look at the BM=W formula, we see that when Deng Xiaoping came back he reinstated the national exam system. What has driven the economy forward is the market, although we did a little bit of B. If we look at regulatory laws, there are a lot of them: contract, property, security, and regulations laws. The Chinese system is unique. We started with hierarchy first, without market. So businesses were extension of the hierarchy. The ideal is for regulators to be simply referees, not players. But in many cases the players are both regulators and players, like State Owned Enterprises.

The anti-trust law will be in effective in China on August 1<sup>st</sup>. But even though the law says there will be anti-trust enforcement agency and committee, there is still a problem. The challenge in China is that we are moving away from a system in which both players and referees regulate firms.

## **2. Discussions**

### **Francis Snyder:**

I think the anti-trust laws are interesting and important. The question is who's going to enforce it. I see it as a characteristic of China where it's impossible to create a single independent regulatory agency. The normal strategy is to bring together all the ministries, having state council as overseer, then having different responsibilities for different bodies. But there are two questions. Do you think this is going to separate referees from players? Do you think that central government will elaborate an overall strategy for economic reform if there are several legal and de facto regulators?

### **Jun Fu:**

That will make a difference in the margin. The unique aspect about Chinese anti-trust law is that there is a power struggle among different government agencies. Anti-trust law is not going to be enforced unless there is a good system of rule of laws. Right now we have a system of rule by law. We use it if it helps, if it's inconvenient we push it aside. So I am doubtful. There are competing forces that delay the enactment of this law. One problem is that monopolies don't want the law. Multinationals do not either. Forces in favor of the law are small and medium size firms, because they are at a disadvantage without the law. Academics want to see the enactment of that law. I guess that the law will have an effect on multinationals in the areas of mergers and acquisition. Foreign firms worry about vital interests of national economy and national security. It's up to the agencies when it becomes effective, they must come up with ways to enact it. I have doubts about administrative laws. But the very fact that it was written into the law at least shows we are getting more serious.

### **Athar Hussain:**

What is the reference point for defining a large enterprise? Some are big for Chinese standard but small by international standard. If you take the international point of view you might say no regulations needed,

if you take domestic view you might say need antitrust laws.

**Jun Fu:**

It depends on product dimensions and relevant markets. It also depends on geographic dimensions. These are all very vaguely defined at the moment. The law has 8 chapters and 57 articles but still in the progress. China first published its foreign investments law with just principles first, and details followed. We are now trying to come up with more detailed guidance.

**Joseph E. Stiglitz:**

I have some questions about how issues in anti-trust law have been resolved in the US.

There is a debate between the US and EU as to whether the objective of anti-trust law is to promote welfare or protect competition. Americans argue it's not about protecting competition but to protect consumers. It's ok to have Microsoft because it is a great innovator, why complain. There is a more protective idea in Europe: it's not necessarily protecting consumers, but protecting competition in a broad sense.

Second, whether it's action or structure? If a firm owns 90% of the market, it is likely to engage in anti-competitive behavior, but it might not. AT&T was broke up. Others argued about Microsoft that it needed to be broken up, otherwise its behavior won't change.

Third, does it make a difference how a monopolist arises? Sometimes a monopolist gets there by offering cheap prices, more innovations. Some people think it's ok to become a monopolist by good actions. Is it irrelevant? Intellectual property rights give you monopoly power over an idea. If that idea is generally broad, then it needs to be circumscribed. If you have a monopoly on a gene of breast cancer, you have to not exercise that right. How do they deal with that issue?

**Jun Fu:**

If we look at the process of forming the anti-trust law in China, the concerns you have were addressed but not in a legal fashion.

China at first was less concerned with market structure than with the behavior. Earlier there was a law on unfair trade secrets, then they moved to concerns about market structure. My interpretation is that now the structure is taken seriously but we do not rule that reaching a certain structure is a per se illegal outcome. But structure will give people an alarm. If you charge unfairly high or low prices, it probably will trigger investigations. If you charge a medium price, then it won't trigger investigations. Looking at market structure is a first cut to look at what's going on.

On intellectual property rights, China respects them as long as it doesn't engage in abuse of them. How that will be acted on will be a matter of time.

## **Session V. Financial Market Regulation**

Main Speakers: Liqing Zhang, Stephany Griffith-Jones, Deming Huo

### **1. Liqing Zhang: Should China Accelerate Its Liberalization of Capital Account?**

Since 1980, financial globalization has experienced rapid development with many developing countries involved to different extent. China also started this process 10 years ago. Some people believe that China should accelerate this process, some think we should be more prudent only. Let me review this issue in two parts. First, I have a brief discussion on the benefits and costs of financial liberalization. Second, I address China's integration into financial globalization and the policy implications.

#### **(1) Benefits and costs of financial globalization: a brief review**

First, theoretically financial liberalization has the following benefits:

- (a) equalizing the capital returns among different countries, which may improve the efficiency of capital usage;
- (b) inter-temporal trade benefit;
- (c) diversification of investment risks on a global base;
- (d) FDI's spillover effect of technology;
- (e) improvement of financial deepening and efficiency of resource allocation;
- (f) strengthening fiscal discipline.

These benefits are usually discussed in standard textbooks. I think they are only potential benefits. In reality they are not as prevalent. Let's move to empirical studies regarding relationship between financial liberalization and economic growth. The most famous study is Dani Rodrik(1998), finding that there is no correlation between the two variables. Some other economists also have similar conclusions. Why is that? If methodology is not an issue, then we must look at the costs of financial globalization.

I believe the most important cost of financial liberalization is financial instability. External debt crisis in the early 1980s and financial crisis in late 1990s are all related to financial globalization. There is a boom-bust circle. At the beginning, capital inflow triggers growth, then in later stage, foreign capital suddenly moves out quickly causing the crisis. My explanation for the boom bust circle is imperfection information. In the early stage, because of imperfect information, many international investors are overly optimistic about emerging markets, so they decide to invest causing excessive capital inflow. When they find that the economy is overheated, once again due to imperfect information, over pessimistic sentiment comes out, and crisis occurs. Some empirical studies indicate that financial instability has a close relation with financial openings.

The other costs of financial globalization include decrease of independence in monetary policy, and

indulging external imbalance.

## **(2) Policy implications**

- (a) Capital account liberalization should be a luxury good for emerging market countries if they are unable to manage the costs.
- (b) Elimination of market failures should be the most important reconditions of capital account liberalization;
- (c) Capital account liberalization should be a gradual process;
- (d) The global cooperation of regulation on capital flows should be very important.

## **(3) Chinese integration into financial globalization and policy issues**

Before 2001, about 80% of capital transactions were restricted by the government. Now the situation has changed a lot. By the end of 2004, more than 50% of capital transactions have been liberalized (table 1). Since 2001, the government has liberalized capital flows by introducing various policies (table 2).

(a) Does China have the preconditions for accelerating capital account liberalization?

No. First, Chinese external positions are not as strong as people believe since most of the large reserves are hot money. Second, the banking sector is not strong enough. It's heavily protected, not open enough. Third, we have insufficient financial regulation and limited exchange rate reforms so far.

(b) Should China encourage capital outflow to reduce its external imbalance?

I don't think so. China is not rich enough to export capital. The 1990s experience in many developing countries indicate that decontrol of capital outflows often encourage more capital inflows. There is very limited evidence that has shown that China is successful in this regard.

(c) How to deal with the surge of hot money inflows?

Using the method developed by UBS (foreign exchange reserves-trade surplus-FDI), the estimated amount of hot money inflows into China surged since July 2005. Since July 2005 to the end of 2007, the estimated amount likely reached at \$800 billion, more than half of the total foreign exchange reserves (\$1528 billion). Since the beginning of 2008, the capital inflows seem accelerating with the amount reach \$ 85 billion in the first quarter.

The capital inflows come into China mainly through the following channels: one channel is mis-invoice in trade transaction, or fake trade surplus; another is abnormal short-term borrowing; the third channel is abjuration of FDI's profit repatriation; another one is individual remittance.

The huge hot money inflows have brought challenges for China's macroeconomic stability. I suppose that China should strength capital control in the short run including both inflows and outflows, adopt one-jump appreciation and then more flexible exchange rate, and other policy instruments towards

external balance.

#### **(4) Conclusions**

To sum up, liberalization of capital account should be a long-term policy objective for emerging markets and implemented gradually and carefully. China should not accelerate its capital account liberalization. In the short run, it should strengthen capital control in order to cope with the surge of hot money inflows.

## **2. Stephany Griffith-Jones: Criteria for Financial Regulation after the Current Crisis**

I want to start by drawing lessons of criteria that should guide regulation both at national and international levels, drawing on current crisis and crises from last decades. Again, the current crisis is the result of two things: the inherent flaws in the way financial markets operate and insufficient and inappropriate regulations. In understanding the current crisis, I think one is the issue of complexity. The financial system has become very complex. Nobody understands the risks and who bear the risks; this is even worse than the conspiracy. This makes it hard to regulate. So some of the criteria for regulation we should think is try to deal with the old problems of financial market and meet new challenges of complexity. The following are some of the key criteria that should guide such design.

### **(1) Regulation has to be comprehensive.**

One thing we saw in the crisis is that the sectors that are either not regulated at all, or slightly regulated have caused more problems. Because of regulation arbitrage, when banks are regulated a lot, instruments like SIVs are created to avoid regulations, or other actors like hedge funds who are much less regulated are created. This is called the shadow financial system, which has link to the regulated system via provision of credit. The fact that this is not inevitable can be illustrated by the fact that the Spanish regulatory authorities allowed banks to have SIVs but imposed same regulations on SIVs as on others. As a result, so they didn't develop much SIVs. So the solution seems to be trying to design total and equivalent regulations of all institutions and instruments. This would discourage regulatory arbitrage and help prevent excessive systematic risks. Designing equivalent regulations on risk weighted assets, both for solvency and liquidity purposes, is not easy, but it is important.

### **(2) Reducing asymmetries of information between market actors and regulators**

I think this is an interesting point that deregulation has often been accompanied by lack of information. What policymakers say is that we're not going to regulate because markets are efficient. I told central bank of Peru to introduce short term capital control. Their convenient excuse is that they don't have the information. There is a very clear need for increased information and transparency as the financial system becomes more complex. One example is the OTC derivatives. There are trillions of them, but central banks hardly know what's going on. Soros and others argue that one possible solution is trying to standardize such derivatives and channel them through established exchanges. This will give you information as well as other advantages. Similar issue exists with hedge funds. There is little known about how much they are shorting, how much leverage they have. It's encouraging that the UK FSA introduced



a tough disclosure requirement for anyone “short-selling” a significant amount of stock in a company conducting a rights issue. It would be desirable if such requirements on short and long positions should remain and be generalized.

**(3) Regulations have to be counter-cyclical.**

If we think the main market imperfection in the financial market is the cyclical feature, one needs to think about rules to fight that. The current policy is the opposite, to make it more pro-cyclical. There are some nice proposals on the table, which argue that you should have higher capital requirements in good times, or when banks are increasing lending to particular sectors which are growing rapidly. More drastic solution is to tell banks not to lend by more than a threshold percent. We could at least do it through this regulatory way. There is the crucial issue of timing. If we do it now, it’s too harsh on the banks because banks need a lot more capital. If we do it later when the crisis is over, it will be harder to enact. So it should be good option to have the rule now, but implement it gradually so we do not kill the bank.

**(4) Regulation needs to be tightly coordinated internationally**

If we want to have comprehensive regulations, we have to tightly coordinate across sectors and countries, as much as possible. There is urgent need for global regulation to be put on the table. China raises concerns about weakness in the regulatory framework.

**(5) Compensation of bankers and fund managers needs to be self-regulated or regulated.**

The Issue of incentives is at the heart of the boom-bust behavior of financial and banking markets. The compensation practices are tied to short-term profits and are one-sided, positive in good times and never negative even when big losses occur. So there’s a real asymmetry of incentives, encouraging much risk taking behavior. The possible solutions to this issue include providing only a fixed salary and accumulating bonuses in an escrow account. If these go well over time, over a cycle, say, then the manager can get the bonus. That will encourage people to think making long term profits.

**3. Deming Huo: Financial Reforms in China**

In these short notes I have prepared I suggest that many new issues are post-WTO in China. When we look at China’s reform that started 30 years ago, we dual-track reform has played a very important role. State and private, non-state sectors coexist in the real economy. But this does not happen in the financial sector. Most banks in China are state- owned. On secure markets, mostly publicly listed firms are state-owned. So dual-track reform has not been applied to the financial sector. I have an interesting observation: before China entered WTO, this backwardness in the financial sector (one track state financial system) did not do much damage to Chinese reform. The problems started after China entered WTO. The appreciation of RMB could be less of an issue if we began with dual track reform earlier since the market could be more able to reflect exchange rate. This means we are at the right stage to talk about dual track reform in the financial sector in China.

In my notes I propose a few further reforms. First, further reforms to improve financial system. The point here refers to dual-track reform in the financial sector. Second, enhance viability of the financial industry through intensified competition. Finally, comprehensive regulations to ensure financial stability.

I guess the only new thing I raise in my notes is that if China has started its dual-track reform long ago for the non-financial sectors, why not start it in the financial side? Only until recently that need has emerged. Maybe it's the right time to talk about that issue formally.

#### **4. Discussions**

##### **Francesco Saraceno:**

What strikes me is that China successfully implemented growth strategy without opening capital account, was capable of attracting FDI in massive amounts without opening it capital account. Can you tell the reason for that? Whether is it just applicable to China or can it be applied to others, like African countries?

##### **Liqing Zhang:**

I think the reason probably is that when China started the process of opening up from beginning of 1980, the process mainly included trade and also FDI, which has been successful. The liberalization of trade, combined with FDI inflow, has made China successful in implementing outward development strategy. By pursuing such economic development strategy, China successfully used its excessive cheap labor resources. But I think now China needs to open a bit to international financial market. I still believe that such process should not be too fast. China's experience probably means that liberalization of trade is more important and realistic than liberalization of capital account. Liberalization of trade makes economy more competitive. Liberalization of capital account creates more instability.

##### **Stephany Griffith-Jones:**

There is an interesting history on this. The European countries liberalized the trade long time ago, but open the financial markets gradually after the Second World War and with not crisis.

##### **James Galbraith:**

In 1980 and 1981, there were 2 major developing countries that were not indebted to western banks: India and China. Every country else was deeply indebted and hence damaged by high interest rates. And these two countries' growth over the subsequent 20 years is related to this fact. In 1995 I organized a meeting on international issues. I tried to persuade two developing countries not to liberalize their capital accounts, and they did not. As a result they got through the Asian financial crisis. "The elimination of market failure should be the most important condition for capital account liberalization?" What is that market failure? Most bankers know very little about the country. What information or signals do they rely on to know whether the country is going well or not? The point I would make is that market failure cannot be eliminated. It is the intrinsic nature of market to have this kind of instability. We cannot eliminate them without making the whole world system very different from what it is now.

**Liqing Zhang:**

I agree with your point. But maybe we can do better in the information issue. Maybe such kind of market failure can be eliminated.

**James Galbraith:**

But it's a matter of the teacher and the student. You can produce all the information and the others learn.

**Joseph Stiglitz:**

Do you think China is learning from American experience so you won't go through what America is going through?

**Athar Hussain:**

Previously the problem with Chinese banking sector was related to non-performing loans in the state industrial sector. But this sector is now doing quite well. Another thing emerging is the accumulation of social security funds. There is a huge amount of financial resources accumulating but not instruments in the hands of investors. Part of the problem is corruption but it's not the only issue. In future cases, it's really important to notice what is happening to the social security system and these funds, and what will happen to the financial sector. Looking at the surplus, the argument is that China saves too much. What also happened is that only 15% of investments in China is financed by bank loans. Most of investments are internally financed. So profit share is high in national income. So rather than thinking about appreciation and depreciation, part of the problem is to shift the distribution of income away from profit and toward wages. We should look at distribution of profit share and wage share.

**Joseph Stiglitz:**

I agree with what James says that Chinese has been successful because it did not liberalize its capital market. The benefits and costs in the presentation were a good summary. One must examine the validity of those arguments. It's very much related to the issue of whether free market has to be good. It's part of the ideology that free markets have to be good and constraints have to be bad because they reduce efficiency, profitability, productivity, etc. If you say that in fact there are pervasive problems in the market then you come to the view that maybe profitability in the market might not be the best signal of what is efficiency. There is growing consensus in the US that profits have become a very bad measure of social profitability.

For instance, the financial sector is responsible for 40% of the entire profit of the US economy. What do they do? They are rewarded with high returns by allocating resources and managing risks. But they allocate lots of capital in houses that were not needed. Most capital is allocated by firms internally, having nothing to do with banks. Did they manage risks well? No. From a social view of point, they have not performed any valuable social function, but they make society believe they have and so we should take away regulations. There are parts of capital market that have made contribution, such as venture capital, but that is a small fraction of the capital market which is mostly related to universities, and they are more

interested in long-term gains, not short-term games. In my mind, the financial market has totally fooled the developing countries into a framework which allow them to take profits. There is a real tension here. I think the language that you used were exactly right. We shouldn't liberalize financial market until we eliminate market failures in the financial sector. Well, that is infinity. There are distinctive aspects of China that made it successful.

**Francesco Saraceno:**

I was thinking of size.

**Joseph Stiglitz:**

Size is important, but the critical thing is savings. The question is China did not need foreign capital inflow for investments because it was saving so much, by repressing wages, bringing corporation profits up, making sure savings are invested, and no instability. Then China opens capital market, borrows abroad, and brings in exchange rate volatility. If China opens up, it's going to be more vulnerable, so do other Asian economies. The reason size is important is that it attracts FDI although with capital control. But many other countries won't attract FDI. There are a whole set of other things: roads, etc. A country can attract short-term financial capital fairly easy if the country does what the capital wants in the short run. I argue that short-term capital inflow is worthless, if not negative. It is only worthy to attract long-term capital.

**Jun Fu:**

Given asymmetric information that we always face, for China to move forward, expecting China to be avoiding mistakes is impossible. Where do we draw a line between market failures and government failures? To me, you don't know market failures until ex post. For each country to learn, the country just has to try. The issue is how to control the magnitude of market failures. My question is, given all we have, financial market is the process of increasing virtual money. It's difficult to say what are the costs of learning and what are the benefit of trial and error. This is a general question for all.

**Stephany Griffith-Jones:**

Just to complement what Jamie said. Not only did China avoid the debt crisis and also Asian financial crisis, this gave an anchor to other countries, a great asset to international community. This so-called inefficient system has done very well. There has been some expectation that China has to be modernized or reformed. Part of being modern is to have a financial system like in the West. But now we really know that it's a myth, that the western system is highly inefficient, people losing their homes, becoming unemployed. Why does China want this system? China has to handle it with great care. You have to choose selectively what adds to the development model. Maybe you don't want any of these problems.

**David Kennedy:**

I am interested in the relationship between financial regulations and capacity of firms to save and invest.

**Carl Riskin:**

It seems that the answer to how China did so well without opening capital account is that it did so well because it did not open its capital account. I remember the early days of FDI; there was a lag between the formal commission in FDI and the provision for allowing profits to be repatriated to investors. It was not clear profits would be repatriated. This has been solved out. As long as investors can take their profits out, they are happy to come out. But now we learn that not giving profits is one way of inflow of hot money. So there is no free lunch.

**Heping Cao:**

I want to respond to the capital control issue. Right now we don't have time to solve these problems. Joe's remarks have assumption that we can solve these problems. Last month China had \$70 billion of capital inflow in one month. The supply of money can not be controlled due to capital inflows. Interest rate policy and deposit reserve requirement policy cannot function anymore. The reserve requirement of deposits is about 17.5% now.

**Zhong Zhang:**

Corporate governance is the strongest justification for mandated disclosure. Security market in China provides a very important platform for the SOE reform. This financial market has some other functions for China. Opening this market to foreign investors might improve the corporate governance.

**Jianyue Xu:**

Another contribution to the success of China is Hong Kong. Hong Kong is one of the most active financial centers. Hong Kong can serve as in front line before money flows into China. Also, after the market system was introduced, there was a release of productivity. When China entered WTO, lots of FDI flowed in. In the last 30 years, in each decade, China economy was successful for different aspects.

**Roy Prosterman:**

It might be a good time to raise broader questions about how the Chinese economy has been doing. I refer to the recent World Bank report which drastically revised figures for a number of countries including China, adjusting for PPP. The figure for China was reduced by 40%, bringing the number of poor people up to 200 million. That is considerable concern to our discussion here.

**James Galbraith:**

The information I got is that the Chinese side was asked to develop price estimates based upon the most comparable international situation. They go to department stores in Beijing, they find that products there are priced the same as international prices. This brings real wages down, but no one in China pays these prices. It serves the purpose of the Chinese government that China is still a poor country.

**Carl Riskin:**

At least Martin Ravallion and some others have criticized this idea that the poverty rate has gone up sharply. They have taken seriously the criticism of using PPP without accounting for the poor. They use a special PPP estimate based on a basket of goods only consumed by the poor. On the basis of that, whose

details we still do not know, the number of poor people did go up, but far less than the number using the other PPP.

**Joseph Stiglitz:**

Is it still the case that the prices they use in this different market basket are flawed?

**Carl Riskin:**

I didn't know what James said before.

**Athar Hussain:**

There is no evidence that price information is reliable or detailed enough. Just as a clarification of PPP, China and India's difference was found to be only 20%, but we didn't think these figures made any sense.

**David Kennedy:**

Let's go back to the panel!

**Liqing Zhang:**

Why China has been so successful? My view is that probably the most important reason is its success in pursuing institutional reform. Reforms started in rural areas, then to cities, and then they opened markets. In terms of opening to the world market, this is the most important in institutional reform. If you look at economic growth rate, in the past 10 years, access to WTO has created a great chance in China. China has been the largest winner of globalization. Another reason is that the government regulated the economy, including keeping a good market order. I do not think China's success can be attributed to capital control because actually China had already liberalized its capital account. In the past 2 decades, especially the past 10 years, it still keeps control on the security inflow. Regarding FDI inflow, China liberalized partially already, but did not complete it. In terms of this area, China has done more than it says. In terms of capital account, liberalization has been much more than it's said. Many provincial governments provide much stimulation for welcoming investors, e.g., providing free land. John Williamson and I have ever talked about Washington Consensus and Chinese economic growth success. He believes China's success is a success of Washington Consensus, because he believes Washington Consensus includes mainly privatization, trade liberalization, and price liberalization. He believes capital control is necessary however, not capital opening.

**Joseph Stiglitz:**

John has a paper in Post Washington Consensus defending the consensus.

**Liqing Zhang:**

I believe that although we cannot completely overcome market failures, we can eliminate to some degree. I assume that with our wisdom, with government efforts, market failures can be reduced in the future. I do not know how long, but I believe things will be better in the future. If we cannot completely overcome market failures, then we keep capital account under control to some degree.

**Stephany:**

I agree with what Liqing said, but want to clarify that market failure not just in China, it's global. You have all the market imperfections coming from abroad. The second point is that even if you do the most rigorous analysis and reach the conclusion as we have today that China shouldn't liberalize, you should recognize that you're going to be up against pressure to liberalize. Banks in the West are becoming desperate, they see that China is where they can make money, and they cannot make money in the West anymore, so they will push capital account liberalization even further. There are also people in China wanting to make money from opening capital account. This is a big political economy issue. You have to bring Joe and James often to convince your government to not liberalize. The long-term interests of China as a country are different from the interests of the firm managers.

**Athar Hussain:**

Larry Summers says that not regulating financial sector is like not regulating nuclear weapons.

**Heping Cao:**

China is getting to a critical point, we can't close the door right now.

**Joseph Stiglitz:**

There are two points about that. We are talking about financial liberalization only regards to short term flows, not long term FDI. Second, a lot of things other developing countries have done is to look for other ways to regulate capital flows without closing the market. You can have all sorts of regulations to discourage short term flows, in Brazil for example. It's just changing the language: to have prudential regulations. That is how people deal with outside pressure today.

**Jun Fu:**

It's easy for us to say when China entered WTO there were lots of benefits. But I think that has much to do with the timing. 10 years earlier the result would have been very different. Strategy has much to do with timing. About market failure, in terms of GDP per capita, Chinese is still very poor. We have only 2 concepts: either government failure or market failure. There is no third concept. Because we do not see market failure, probably there is an accumulation of government failure that we just do not see.

## **Session VI. Environmental Regulation**

Main Speakers: Ye Qi, Jintao Xu

### **1. Ye Qi: Challenges in Environmental Regulation in China**

#### **(1) The environmental problems in China**

In May 2007, there was a massive outbreak of algae in Taihu Lake, stopped the water supply to the 4.5 million residents in the city of Wuxi. The price of bottled water shot up in Wuxi. In June 2007, there appeared another outbreak in Chaohu Lake, not very far from Taihu. And In the same month, this happened again in Dianchi Lake, Yunnan province.. The three lakes received the most funding for pollution control, then all three fell to algae outbreak. These three lakes were modeled lakes in 1990s, you can imagine what the rest of lakes and rivers are like.

**(Joe:** Is it pollution that is causing the algae boom?

**Ye Qi:** Yes, it's pollution, from both industry and agriculture.)

It is a consensus that China is suffering wide spread environmental degradation and natural resource depletion, resulting in severe damage to human health and the economy. We also know about and agree on the causes, rapid economic development without proper prevention and treatment measures of the environment and natural resources. Even though there are many laws and regulations to protect the environment, the compliance and enforcement have been very poor. This is my main topic today.

#### **(2) Why such poor enforcement?**

To understand the institutional cause for such poor compliance and enforcement, I looked at the three aspects of governance: the rules, players, and implementation. The key elements for poor enforcement at the local level (not national level) are: national development goal, top-down accountability, strong taxation with lax public budgeting, ineffective judicial system.

Who is to enforce? Not a trivial question. It's really the local government, not the central. Local governments are bad enforcer because they lack of motivation, capacity, and pressure. Of course, businesses are even worse.

This has to do with the promotion system. Local government officials get promoted based on their performance evaluation by the central government. This is what I mean by top-down accountability. The central government has this growth-oriented system. So local governments put priority on economic growth. They are not accountable to their constituencies. The national development goal has been to modernize Chinese economy for the last 30 years. In the past few years, a very effective way to reach this



growth-oriented goal is to encourage local governments to compete against each other. With a system like this, the local governments can choose economic growth or environmental protection. They can't have both.

Further more, there is the issue of budgetary constraints. Local governments now have less fiscal capability to fulfill their responsibilities, making it difficult for them to allocate funds for environmental protection. Their capability is quite limited. What you see is local government is doing 70% of the work with 50% of the money.

There is a mechanism that the public can file complaints or call hot lines for problems. But this pressure does not work because the local government can choose whether or not to respond, so it doesn't make a difference. It's really difficult to file a case against the government. So the measure isn't effective.

You can use a similar diagram to see why the government is so enthusiastic about urban growth because by developing this urban land the local government can really receive the financial revenue from doing so and show their good performance regarding development. So both political incentive and budgetary constraints work in the same direction.

### **(3) Possible solutions**

Can we fix it? First, can we fix the national development goal? The central government calls for scientific development outlook. But the overall goal has not changed. Second, can we change top-down accountability? How are top leaders of government selected? Still the old way. Democratic (bottom-up) accountability is not there yet. Third, how about the public financing system reform? There is a scheme being worked on right now, hopefully it will work, I do not know. Fourth, to deal with the ineffective judicial system, we need to make public pressure work. Look at environmental monitoring system, there are 4 levels right now. All these stations are administered by local governments, so they can report whatever they want. A lot of people say one way to respond to this problem is to integrate the whole environmental protection system. We think it's not realistic and against the law. But we propose integration of gathering and disclosure of information and data. This is one way to start addressing the problem.

## **2. Jintao Xu: Collective Forest Tenure Reform in China**

I am going to introduce our study to compare collective forest tenure structure before and after forest tenure reform based on a nation-wide survey.

You can see this clear division of forest cover, the forest's all in the east and the west is mainly covered by desert. The goal of China is to have 30% forest cover. Surprisingly India also believes in this magic 30% number. At least they have one thing in common. Within the forest sector, China's territory is usually divided into 4 forest regions: the collective region, the state forest region, the no forest region, and

Tibet and Taiwan. Forest sector in China, compared to other sectors, remains very quiet in terms of reform, highly regulated in many ways, ownership might belong to village but government still tightly control land use. There are lots of government programs and funding in place to leave private investments no room to come in.

## **(1) Forest tenure in China**

There are only two types of ownership: collective and state. There is a smaller share of (42% of forest area) of state owned, but a larger share in terms of total volume (68% of forest stock)

There are lots of names for management types. To do analysis, you have to group them into 5 or 6 types: individual household management, partnership, villager cluster or natural village, outsider management, collective management, ecological reserve. In the collective forest tenure, village collectives are as legal owners, farmer households. A group of farmers, outsiders, are all entitled to contract and manage collective-owned forest land. The decentralization of management was slow and not smooth since 1981. During the reform, the partnership type became very fashionable. The purpose of the reform is to reduce the share of collective management and increase individual household management.

**(Joe:** Can you explain what a collective is?

**Jintao Xu:** It is village. We have administrative village, which means a group of natural villages together. An administrative village is like a government, although it's not part of the government.)

**(Xifang Sun:** In the tenure policy for agricultural land, the government has the right to take away the land from farmers for public purposes. Is this also the case in forest tenure policy?

**Jintao Xu:** It's more so for forest tenure, especially for ecological reserve purpose.)

## **(2) Forest tenure reform**

Decentralization of forest tenure reform started at the same time as agricultural reform, but the process has not been as smooth. Now there is a new round of forest tenure reform. Forest tenure reform in reality is a marginal reform, in terms of increasing household management of the land. It started in Fujian province because it did not reform in the 1980s. More than 10 provinces issued new reform policy so far. Although the land reform is marginal, there is something new. All the reforms plans have to be approved by the village committee, by 2/3 votes. The contracts term is much longer, it used to be 5 to 10 years, now it's all at least 30 years. New rights are given to farmers including transfer, collateral, etc. All farmers get very nicely designed certificates, which can be used for collateral purposes.

**(Carl Riskin:** A definition question: what constitutes a forest?

**Jintao Xu:** Thirty percent coverage used to count as forest, now it's down to 20%. In India it's only 10%!

We surveyed nine provinces to get data on what is the baseline of the reform. We collected data for the year 2000, 2005, and 2006. Before and after the reform, the change is not so clear. But you see the area share of individual household management increased a little in most surveyed provinces. Average contract length is consistent with the new document, which are 30 years or more. There is a large standard deviation of contract lengths. We asked farmers if they have those rights, and some said “yes” and some said “no”.

When you do reforms, you worry about two things. The first concern is whether reform leads to deforestation. We find timber harvest has increased a lot, 3 times higher than before. If farmers harvest then they reforests, so it’s ok. Areas of afforestation increase in the same proportion.

The second concern is farmer’s income. We find that there is a change in structure of household income. In areas where reforms were active, the share of forest income increased. But in some areas where the land redistribution is not so significant, the higher timber price is the main reason, not tenure reform.

### **(3) Implications on regulations**

We cannot expect to reform forest or land tenure without changes in other regulations. Impact of other regulation is very important. The most important one is logging quota. In some places you see logging increased by 3 times, implying the government relaxed logging control. What about ecological services? The forest sector is supposed to provide society some ecological services. Some precautionary measures to keep ecology reserve forest were taken before reforms. Forest tenure reform is accompanied with more rights to farmers. The land market develops, the government concerns about weak farmers losing land quickly without knowing about their rights. In Fujian province they’ve already adopted policies to regulate land transfer.

## **3. Discussions**

### **Francis Snyder:**

I have 2 questions. If you compare food law to that in Europe, there’s very little risk analysis or precautionary principle. My question is whether risk and precaution are taken into account in regulating food, forests, etc? Are they regularly used? Second question is: there is an article on transition from Rule of Law to regulation to governance as a process of networks. These examples emphasizes on top down command and control. How about governance through network? Any thought on rethinking institutional framework involved in forest management of environmental protection?

### **Qin Gao:**

My brother-in-law studies water supply in China. He says that in some provinces the local government officials require to hold their pollution standard to a certain degrees so that they get promoted. Is that a movement in the future?

### **Carl Riskin:**

These two papers deal with two most severe environmental problems that China faces: Water pollution and desertification. The lesson that I took from one paper is a pessimistic one. We need to move from the question of what kind of changes must take place to make local governments interested in environment protection, to the question that if they were interested, what they can do and what measures they can use. Are the measures more direct, like quotas on pollution, or are they through things like price mechanisms? Is there any evidence that efforts to reduce deforestation are working?

**Ye Qi:**

First, for the risk analysis, ever since late 1970s there has been practice of environmental impact assessment, which was made into a law in 1980 and revised in 2002. For every major construction project, it has to go through this formal assessment. By now, almost 99% of the projects did go through this assessment. But that is on the book. The problem is there are major flaws in doing this assessment. Say you hire me and pay me to assess the environmental impact then of course I will let you pass.

In terms of the network governance, I think it's really growing. If you read the 1989 version of environmental protection law, it is talking about what the government does to protect the environment. Now the government recognizes that there are other forces. Information disclosure is a very important tool for this type of network participation by the public.

I was not that pessimistic myself. I'm sorry if I sounded pessimistic. I think that the data are so critical. The local governments currently collect, compile, and release all the data on environmental quality in their region. There are strong incentives to manipulate the data. We propose vertical integration on data collection and release. Then the public and everyone can help the government enforce. This could be one very effective way to deal with this problem. Now the local governments do not have a pressure or capacity to enforce. Another proposal is to use the judicial system. If you don't allow this to take place, then there are no teeth. This is all moving forward. Prices, taxes, fines, etc. are all being studied so local governments can have specific measures. This is very elevated level of awareness, lots of interests and enthusiasm. There are good reasons to be optimistic.

**Jintao Xu:**

Since the mid 90s the forest sector shifted their goal from timber production to ecological conservation. One measure of ecological conservation is to set aside large reserves. Our national leaders are very pro-individualization and much of forest land is individually managed. The problem is it's more like a political thing. If there's a forest problem, the forest minister gets removed from office, so forest minister has incentive to protect forest. In terms of desertification, forest sector has been successful in convincing public that forest preservation is important for preventing deforestation. But now they're lowering the standard so a shrub counts as a forest!

**Jun Fu:**

I notice in your presentation, one of the remedies you cite is democratic accountability. Pollution is a public bad and absence of pollution is a public good. Markets don't support things of a public good nature

well. Why democratic accountability can help deal with the problem? And, what is the mechanism of incentives between deforestation/afforestation on the one hand and privatization on the other? What is the economic explanation for that?

**Ye Qi**

I do not have theoretical explanation. If you look at unrests, a lot of them have to do with environmental damages that villagers suffer. When these kinds of things happen, it's because lack of actions from the government or polluters. In many cases the government chooses to do nothing or drag on. If there is a way to allow this kind of pressure to actually make some progress in improving environmental quality, it will work. Look at Japan in the 1960s. They had lots of serious environmental damages. However, they used their court, allowed litigation to work with government support in many cases. In our cases in China, making this kind of complaints or litigation does not really work. You do not really get support from government. Rather than top-down accountability, you need a way to allow public interest to realize itself.

**Ling Li:**

Wuxi area is doing much better right now mainly because crisis made them reform. In the lake area, they closed down 1500 factories. So you can see how toxic that lake water was. It's a rich area in China. They get rich but their health situation has got worse, all kinds of cancer because of pollution problems. Around lake area, there are three local governments. How can they cooperate together? There are other rivers and lakes where the problem continues because a crisis has not occurred yet.

**Zhiyuan Cui:**

About the new form of network governance, this system was not operating very well in China. But in the recent earthquake, there was an example of network governance. The government invited citizens to become social monitors, and they selected 308 social monitors to monitor public donation. There has been a spread of this to other fields, including environment. In Changzhou there have 40 citizens monitoring the river quality day and night. It's a new form of governance forming in China.

**Joseph Stiglitz:**

Similar question is the tension between the national government and local governments. It's clear that the national government is aware of that. The government sets norms knowing that they are going to be cheated. But they can set it up knowing there is some risk that is ambiguously defined but lurking in the background. When the government says we want to slow down the growth from 9 to 7%, no one takes it seriously, but it is a signal that they should not be overly ambitious. Same thing when they say that they should be worried about the environment, it might affect behavior. One big issue in global warming is compensation for avoidance of deforestation. If someone comes and says we would pay China to not deforest, could there be a system in China to make this work?

**Jintao Xu:**

It's very difficult. In any land use, you have a leakage problem. You reduce deforestation here, it happens elsewhere. You need a nation-wide system.

**Joseph Stiglitz:**

In state forest, is there that much illegal logging going on?

**Jintao Xu:**

Yes, as much as 50% by the SOE themselves. I want to answer Jun Fu's question about the economics of deforestation. In China in the 1980s, people believed that collective management was more efficient, but in the last few decades, experience shows it's not true. In areas with household management, afforestation has been better.

**Jun Fu:**

That's the observation. What's the logic behind it?

**Jintao Xu:**

Forestry needs stable expectation. People need incentives to invest and know that they can collect the fruits in 20 years. Collective management means common property problem. In the last 10-15 years, the government's efforts to increase farmers' incentives to invest by stabilizing rights has been obvious, creating incentives to protect land.

**Ye Qi:**

Afforestation is doing pretty well in China. The way how the central government understands the norms that local government does just becomes a way of regulation with Chinese characteristic. I think the central government does understand well these standards or goals are not going to be met. But now the central government gets too serious with these goals, and they get complaints from local governments. They are not supposed to be serious.

**David Kennedy:**

Joe asked me to prepare a few comments about the broader project. This past discussion framed well what we're after: a type of alliance between new ways of thinking about regulation. A common theme in the project is what gives us reasons to be skeptical about neoliberal ideas.

What is the range of economic theories, what's the data, if you're trying to strengthen the policy arm of the state? Now China gives us an example of having done a million things to resist having autonomic policy space. Ideas about how you organize yourself really matter. And if you leave open room for policy space, what do you want that space for? Suppose you did not liberalize capital account, then for what? As soon as you start developing an economic analysis that goes against the liberalization rhetoric, you then need to figure out what the alternative is. That takes us in the direction to regulations and laws. We thought looking at regulatory experience in a variety of sectors would give us a new sense of what works and what doesn't. What can we learn for financial sector from what's going on in the environment? Do financial problems help us think about democracy problems? Do antitrust ideas help us think about environmental problems? What types of new possible regulatory modes would emerge?

When you run into a problem where economists start talking about law and regulation, you run into another body of thought in law that has been thinking about this for some time. Is there an alliance between economics and law? Are there legal reasons to be skeptical of the liberalization argument being forwarded by folks promoting neoliberal ideas? If we take Francis's map of the regulatory system, looking at it from the bottom up, it turns out that it's all over the place, not just in China. They are all over the world, in the EU. There's a set of legal technologies that might add to our grab bag of critical observations about the consequences of liberalization. There is also within laws a whole bunch of literature that are trying to invent new modes of regulations, such as soft laws, networks, setting goals you don't intend to be met, etc. It puts you as a regulator in a whole different frame of mind.

It seems to me that some of the common themes in the discussion we had today would be: if we could be more precise on the economic side, what are the critical economic reasons for regulation? And how does that knowledge intersect with new knowledge from the legal side that is itself critical of the idea that property rights could be clarified when there are conflicts of ideas about spaces of rights? Those are the themes I saw. And I saw them because I wrote a paper on just that! This is the paper that was supposed to be in materials. The paper argues for an alliance between heterogeneous thinking in economics and the law that have developed analogous doors. This dynamic might be productive in helping us look at sectors that we are most interested.

## **Session VII. Labor Market Regulation**

Main Speaker: Fang Lee Cooke

### **1. Fang Lee Cooke: Labor Market Regulations and Informal Employment in China**

#### **(1) The Development of China's labor market**

The development of China's labor market can be divided into roughly 3 stages, but there is no black-white demarcation. The first stage was a controlled labor market through "Danwei System" along urban – rural divide in the state-planned economy period. The second period (1980s – early 2000) was characterized by deregulation. Rural migrant workers came to town to work, and workers were laid off from state-owned enterprises and collective-owned enterprises. After 2000, a third stage is beginning in which the government seeks to reregulate the labor market in order to offer better employment protections and labor rights to workers, like recent labor contract laws, which is quite controversial so far. I will talk more about it later.

On the role of labor market regulations, there are a lot of debates based on equity and efficiency considerations. For workers, there is the equity issue through labor standards and redistribution. Workers need basic forms of security, such as labor market security, employment security, job security, work security, how workers are organized and represented, etc. But some argue that another goal of labor market regulations is to stop and prevent the recreation and exacerbation of labor market segmentation.

The operation of labor market involves a number of stakeholders: the government, workers, employment agencies, and trade unions. Each of them plays different but sometimes overlapping roles. I will discuss the working conditions of migrant laborers, and then get to the role of labor market regulations related to informal employment including its gender implications.

#### **(2) Characteristics of informal employment in China**

Informal employment can be found in both informal and formal sectors. It remains poorly regulated or unregulated at all in many countries. Job quality is often very low with bad working conditions, the workers are poorly paid and lack of skill training.

Informal Employment in China always existed, but in small scale until recent years. Mostly people work full time, but if they can't find full-time job they take on plenty of part time jobs. The informal employment was marginalized but has seen rapid growth since 1980s onward and especially 1990s because of growth of the private sector, downsizing of the state sector squeezing workers out of formal sector, encouragement of government policy for people to take on self-employment ( especially for new graduates and the unemployed). When people become wealthier a lot of community services are



employed that are usually informal. The term “flexible employment” is more preferred by government. There is no agreed definition of what “informal employment” includes and how it is measured. It is estimated that over 150 million engaged in informal employment in the urban area. Types of people engaged in informal employment include: 80 – 90% of laid-off workers, rural migrant workers, urban unemployed people, retirees, entrepreneurs and free-lance professionals.

Types of organizations where informal employment is found include: informal sector (usually non-skilled informal employment, community services, etc.), formal sector (enterprises, government organizations, etc.), and loosely-defined informal employment organizations.

Working conditions of rural migrant labors in urban areas are very poor. Laid-off workers are more protected than rural migrant workers in urban areas.  $\frac{3}{4}$  of the rural migrant workers don't receive wage on time, especially in construction sector and local governments are the worst offenders. Majority of migrant workers don't have employment contracts and those who suffer work-related injuries have no insurance. Over 80% of them did not participate in any form of social insurance. 25% of them earned below local minimum wage.

### **(3) Labor market regulations related to informal employment**

There are a few labor market regulations applicable to informal employment. Minimum wage regulation (1993) and revised in 2004 divide wages into two types: monthly and hourly, applying to full-time and non full-time workers respectively. Other laws include labor market wage rate guideline(1999), employment promotion law(2008), labor contract law(2008), etc.

The effect of labor market regulations is limited, which is also covered in the discussions of other regulations. The employment-related regulations are essentially administrative policy regulations that have limited authority and enforceability. Labor contract law arguably offers more protection to workers but has met strong resistance from employers. The interpretation and enforcement of laws and regulations remain problematic, e.g. who should pay minimum wages? how to set the wage level? etc.

### **(4) Scope and level of social security protection**

There are limited schemes that provide partial protection to urban workers. These schemes are very expensive and hardly any scheme is available and afforded by rural migrant workers. Many of the schemes are not effective.

Some local governments introduce their own schemes, e.g. Shanghai Model and Beijing Model. In the “Shanghai Model”, workers employed in the informal labor organizations can participate in all sorts of social security schemes. Both employers and employees receive discount to contributions but the employees can enjoy the same benefits as those in formal employment. Since this favorable policy targets at laid-off urban workers instead of rural migrants, it triggers opportunistic behaviors of informal labor

organizations. The “Beijing Model” targets rural migrant workers by providing special regulations for their health insurance. It is the employers who pay cost for migrant workers.

### **(5) Emerging forms of organization, representation, and protection of informal workers**

The healthy development of a labor market requires not only a sound legislative framework and a balanced social security system, but also an effective representational mechanism for workers. Local governments, trade unions, self-organizing networks, and other service bodies play a role in organizing the informal workers.

About the role of trade union role, there is only one type of trade union that is recognized by the government. The government has urged the union to organize for interests of migrant workers, but this has received little attention by the trade union. In 2003, the All-China Federation of Trade Union made an announcement that officially classified rural migrant workers in urban areas as “members of the working class”. Two ways are adopted by the trade union to organize the migrant workers. One is “work-place organization”, i.e. to ask employers to recognize trade union. The other way is “distant organization”, i.e. to operate in labor markets and hold job fairs (offering such services as training, etc.). In principle, the trade unions should play an institutional function since they are funded by the government, but, in reality, they don’t play this kind of role at all. Trade unions’ efforts in organizing rural migrant workers remain weak. This is mainly a result of persistent resistance of private employers to recognize the trade union. This is partly because workers are unfamiliar with the concept of workplace presentation.

There were 35747 employment centers in 2005, more than half of them are funded by the labor authority. In many regions job centers exist but most people get jobs through connections.

### **(6) Gender implications**

There are more women than men working in informal employment in urban areas. Men on average earned a much higher hourly wage than women. There is a M-shape pattern in the age of women rural migrant workers; when they have children, they don’t tend to work.

## **2. Discussions**

### **Athar Hussain:**

In 2005 some regulation was passed that there cannot be discrimination between migrant and non-migrant workers.

### **Fang Lee Cooke:**

Implementation is a problem. China does not lack regulations. Labor laws are advanced and detailed.

### **Athar Hussain:**

There are two issues here: collecting contributions from migrant workers and compensating them. A lot of problems exist in how they can get their benefits. Local unions are keen to collect contributions from migrant workers, but the workers don't know how to collect benefits.

**Fang Lee Cooke:**

There're not even talking about the full coverage of social security, pension, etc. They're only talking about workplace injuries and big health problems. The migrant workers don't even think about receiving pension because they're usually young workers. Main problem is affordability.

**Athar Hussain:**

The data for looking at this issue is from the city. A migrant worker may move around throughout so there's lack of data that aggregates the workers together.

**Fang Lee Cooke:**

A system of integrating migrant workers is almost the only way forward. Another difficulty is, for workers who work for different employers, which employer contributes to the fund? People who are employed through job agencies, who is the employer? This is most relevant for nannies.

**Athar Hussain:**

They may learn good and bad lessons from the US. MacDonald's scheme.

**Fang Lee Cooke:**

Go back to the issue of nannies. Both parties are at risk. If the nannies cause trouble and disappear, where can employers find them? If nannies hurt themselves on-the-job, sometimes employers feel responsible and pay medical expenses, but what if expenses more than what they can afford?

**Carl Riskin:**

What is the gender composition? What is the proportion of what is considered as migrant labor as a proportion of informal labor force? Are there any data on that?

**Fang Lee Cooke:**

A high proportion of people in the informal employment are women. There is no nationally agreed number of migrant workers.

**Athar Husain:**

I can provide Carl with these figures.

**Qin Gao:**

An issue related to the minimum living standard assistance policy is that urban laid-off workers are reluctant to take many jobs, so rural migrant workers take those jobs, then the urban workers complain.

**Fang Lee Cooke:**

Female migrant workers are more hard-working and take jobs for a long time, but the urban ones are less hard-working and tend to quit more. But, there's not much competition between the two because the migrant workers take jobs that urban people don't want.

**Carl Riskin:**

Any information on how many of the workers get Di-Bao?

**Fang Lee Cooke:**

Di-Bao system is only restricted to urban workers, not migrants.

**Athar Husain:**

Most people who get Di-Bao also work informally. Only older people get Di-Bao. If you're young and earning, you don't get Di Bao.

## Session VIII. Transition, Openness, and Regulation

Main speakers: Athar Hussain; Roselyn Hsueh

### 1. Athar Hussain: Regulation in Transition

There is no regulatory equivalent of a blank sheet of paper. The introduction of new regulatory regime is a shift from one regime to another. So there are always remnants of the old regime.

#### (1) Transition

A general view of transition is that transition involves both phasing out old regulations and institution of new ones. The problem is not just withdrawing government role in certain fields, but also filling roles where government weren't performing before, such as social security and protection. In China, the enterprises provided much of the social good, while the government made managerial decisions. The government did what the enterprises in a market economy would do and enterprises did what the government normally does in a market economy. So analysis on regulatory regime should be conducted in terms of the following.

##### (a) Target of regulation intended outcome

In many cases regulation may have both intended and unintended outcomes.

##### (b) Source of the regulatory law and instruments

There's no single source, but various sources of regulatory instruments. Much of the reform in China was not introduced in form of law, but in the form of temporary regulations. However, in China, temporary regulations have a habit of being long term. For instance, social security system has been grounded on temporary regulations, and there have been no social security law because people can't agree on the contents of the law. Another source of regulatory laws is international agreements and conditions, like through trade agreements, etc.

##### (c) Institutional architecture of regulatory agency

In Chinese context, China has 4 levels of territorial government, which are more than other big countries, which creates problems. There is no clear partition between regional and central governments. One feature is the two lines of authority, which is important. For financial bureaus, there is the vertical line of authority from minister to lower level, but they are also subject to a horizontal line, i.e. provincial governments. The second line dominates because the bureaus are financed by provincial governments. The two lines of authority create a lot of tension in the institutional architecture. Another feature is replication. Every organization has the central level replicated at the provincial level, but not at the lowest level of government. The central government collects more tax revenues than it normally spends. But each level of government bargains with others to keep revenue, but push responsibility. Usually low tiers

of government are responsible for much of social spending, such as education, health, etc. These are the problem areas during process of transition.

## **(2) Salient features of pre-transition**

Features of pre-transition cast long shadows on regulatory structure.

### **(a) Rural-urban dichotomy**

Rural-urban dichotomy is a abiding feature of China, taking various forms: household registration system, along with series of entitlements to certain benefits and distribution of government subsidies. Go back to Joe's point: urban areas are heavily subsidized but rural areas not. The distinction extends to investments, with higher proportion of government expenditures going to urban areas rather than rural areas. This has relevance to the earthquake, building regulations existed in China to guard against earthquakes only apply to urban areas, not rural ones.

### **(b) Land ownership**

Land in rural areas is owned by collectives (not state) and not subject to the same building regulations as the urban area, so attracts a lot of people because it's cheaper.

### **(c) Low labor and population mobility**

This feature is important, casting long shadows on the government structure in China. The place of origin is important. It's where a person originated from, not where he live and work, that matters. So whether or not a child gets education depends on their registered place, not where the child actually is. When population is immobile, this creates problems for migrants. There are about 140 million migrants now.

### **(d) Central-local relationship**

Much of the discussion is related to this feature. Local governments have a great deal more autonomy than what would be suggested by looking at the structure. We assume that more centralization and local-central government move in tandem are good things. But Joe's point is that there is no ideal answer to the centralization vs. de-centralization question. In some sense, tension we get from central vs. local follows certain forms of hierarchy. It's the logic of states-craft. China has implemented a system with the central government very aware of its power.

## **(3) Impacts of transition on regulatory regimes**

### **(a) Change in respective role of enterprises and the government**

Government has to assume provision of certain goods away from enterprises. Over a quarter of school spaces were provided by enterprises, not local education authorities; hospital beds were largely provided by enterprises. The government were not prepared to assume that role. In China, the government is still developing the capacity to provide these functions. Transfer of decision-making happened quickly, but

social transfer (social goods provision, social systems, etc.) has been lagged behind. The consequences are lack of synchronization between transfers.

(b) Adverse impact of economic reform on inherited regimes

Reform has changed incentive structures, like the household registry reform. Before, migrants couldn't get job, but when enterprises can make profits from cheap labor they start hiring migrant workers.

(c) Open door policy ramifications

China is a very open economy now, so there are conditions that it has to observe not only because of international organization membership but as requirement to trade, like food standards.

(d) Knock-on impact on regulatory regimes---deterioration of public finances

The first round of reform led to decline of the share of government revenue in GDP, which resulted in the knock-on effect, i.e. the government was reluctant to take on social responsibilities. During the planning period all investments of public utilities were financed from the budget (e.g. electricity generation). In 1980s national income grew rapidly, but government revenue as a share of GDP was falling. Before reform taxes were 30% of GDP, after reform the ratio of tax revenue to GDP became 9%. The government was incapable of funding investments from budget. So they had new forms of organization and local governments can invest in public utilities. Local governments also wanted ownership interests (e.g. owning electric companies, etc.) in return. Essentially, China had new regulations without planning or thinking and the demand for investment became the main driving forces to establish regulatory agencies. We notice some things in China's regulatory field: abolition of the Ministry of Electric Power and other line ministries and creation of super ministries; reliance on directed bank credit and the emergence of Non-performing loans; reduction of subsidies to social sector; and rise of extra-budgetary public finances.

(e) Regulation of population

This is an important part of Chinese lives. Household Registry system was introduced in 1955 for rationing purposes and then became system used for other things. 20 years ago, you say to a peasant to get status as a non-agricultural citizen he or she would be very pleased, but now if you tell them you want to abolish distinction between agricultural status and non-agricultural status, the peasants are not happy because of land ownership.

## **2. Discussions**

**Joseph Stiglitz:**

There are two arguments, inefficiency and conflicts that arise from duplication. Is there any debate on this in China?

**Athar Hussain:**

We're more aware of the local conditions. China is such big country that levels of development and what

people want are very different. So the local officials should know better.

**Joseph Stiglitz:**

What happens when there's conflict? There is argument saying that if there's conflict, it's the delegator who has the ability to resolve the conflict, but as Athar describes there's no clear demarcation.

**Athar Hussain:**

The central government ultimately has one weapon since all appointments above certain level have to be appointed by the center. Local officials know their career depend on central leadership opinions. Further more, there is the disciplinary power of the party. The party oversees that the system won't go out of line. So, essentially, even though local governments have a lot of power, the central government can exert their power in the above ways.

**Joseph Stiglitz:**

Does the party have separate regulatory structure for e.g. environmental regulations? Are there two tracts going on at parallel?

**Athar Hussain:**

The party does discuss all important regulatory issues.

**Akbar Noman:**

When the party gets involved in the design of regulatory regimes but not in implementation, do they monitor the implementation?

**Athar Hussain:**

Every big organization has to have a party committee overseeing them.

**Roy Prosterman:**

One interesting area in terms of potential importance of communication between development economists and government administration specialists is the rural land contracting law. Farmers lose land for migration only if all members of households move to large cities and change their household registrations. The law is also clear that transferee is supposed to be able to hold on to the transferred land even if he moved to big cities. Probably true that they can make multi-year lease and get payments and not lose the land rights. But farmers have no awareness at all of these rules, even some local authorities know of them. This is an important implementation issue.

**Athar Hussain:**

Agricultural land has different status than other lands so the area may be urbanized but people still retain titles to them.

**Carl Riskin:**



Is there evidence of the central government using fiscal pressure to extract benefits from local government?

**Joseph Stiglitz:**

In China, there's a very formal structure, and little bargaining over the rules as opposed to U.S. Congress where there's a lot of fighting over formulas at the national level. Carl's question is that there seems to be more discretion in the state-local relationship. Whether they use that discretion as an instrument for broader issues is important. In US, officially, the federal government has little regulatory power but it has exercised a lot of regulatory power by saying such things like "if the university is funded by the state and does not have equal physical educational facilities for gyms, you lose your highway funding". The two things are totally unconnected, but the threat is so powerful that nobody would resist it. The question, in China's case, is that with less formal structure, are these kinds of things going on?

**Athar Hussain:**

China's case is more discretion-based. Henan gets the least transfer.

**Joseph Stiglitz:**

In terms of environmental policy, do you see these kinds of transfers as threats for inducing good environmental policy?

**Ye Qi:**

In US, this happens a lot. This doesn't exist in China, but that's something we recommend the central government to consider. That kind of discretion for the agency and for individual authorities has a lot of implications for transfers. Old fashioned lobbying occurs. In Beijing, many provinces have their local government offices, by which they can persuade some policies.

**Joseph Stiglitz:**

Is it official lobbying?

**Ye Qi:**

Yes, it is lobbying.

**Joseph Stiglitz:**

If you do a regression one issue you might be able to infer is that, while it's not transparent, in effect the government is giving more money to those with good environmental practices. Has anyone done this?

**Ye Qi:**

I have not seen any empirical analysis of this, but I think the answer is no. There should be no correlation between the two. In fact, if you indeed do the regression you might get the opposite results, i.e. those provinces and cities that do better economically tend to get more money.

**Joseph Stiglitz:**

That would be interesting to do.

**Athar Hussain:**

It has been done and it's found that coastal provinces (the richer ones) get higher funds from the central government.

**Jin-Yeu Tsou:**

Good-practice guidelines exist but the implementation has been very fragmented because of the geographic differences of environmental issues. Gradually it will solidify. But at this moment the data we need to control environment pollution are not available yet, but over time, environmental data will become more and more available.

**Athar Hussain:**

The regression that Joe suggests can be done in India since the data for India is much longer. In China, the number of data points is not large enough to run any regression.

**Heping Cao:**

More subsidies went to coastal regions, like Beijing, Shanghai, and Tianjin. The central government uses national tax revenue to compensate the coastal areas and gives less compensation to the middle provinces such as Yunnan. But they compensate a lot to Xinjiang. Because these provinces are at the bottom and they do not need to ask for transfer since the central government will give them anyway. You may notice that Inner Mongolia get less compensation compared to Muslims Xingjiang since Inner Mongolia is a friendly ethnicity in China. Usually the central revenue subsidizes the richest and the bad guys, the middle area will not get funding. This is a big problem for transition in China. They need to unify incentive system in transition.

**3. Roselyn Hsueh: China's Liberalization Two-Step---A Response to Globalization**

China has extensively liberalized FDI and trade in the last 20-25 years. There are dramatic inflows of FDI into the country. The policies that allowed this to happen are different from both the state model in its East Asian neighbors and universal liberalization program in other countries. South East Asian economies actually discouraged FDI to protect their domestic industries through export-oriented industrialization; Latin America countries adopted the opposite strategies. Then the questions are: how has the Chinese Government has structured foreign competition and what does that imply?

**(1) Methodology**

The findings are from a larger study, which uses a comparative case approach to explain and document China's distinctive strategy of integration into the international economy. The study involved 18 months of fieldwork, semi-structured interviews of government officials, industry representatives, foreign

delegations, and domestic and foreign companies in the coastal and western provinces of China. The research design selected industries, subsector, and company cases. Case studies include two industries: telecommunications and textile.

## **(2) Liberalization two-step: understanding China’s state control of FDI**

The Chinese government has liberalized FDI on the aggregate level but chose. to regulate at the sectorial level. By this bifurcated strategy, the government tried to meet its twin goals of complying with WTO commitments and retaining some control. In strategic industries, the government has centralized control and strictly managed the level and direction of FDI. In less strategic sectors, the government has relinquished control over industry, decentralized decision-making to local authorities, and encouraged private investment and FDI. At the sectorial level, the degree of liberalization and regulation is actually quite different and provides stark picture.

## **(3) Variations of state control across industries**

To better understand how patterns of state control vary across industries, I conceptualize state control along three dimensions of goals of state control, state-industry relations, and methods of state control. Goals of state control reveal whether the central government takes a laissez or strategic orientation toward market players. The state-industry relationship is the level of government that manages industrial development and the extent of state intervention, reveals whether the central government’s control enhance or undermines its authority over industry. The methods of state control reveal whether central government control emphasizes liberalization (introduction of competition) or regulation (reformulation and creation of rules). By “liberalization”, I refer to both policy measures and company-level interventions taken by the state to introduce competition and enhance of the role of markets. “Reregulation” is defined as the reformulation of old rules and the recreation of new ones to achieve state goals. This conceptualization identifies at least four types of state control: strategic reregulation, expansionary reregulation, subordinated reregulation, decentralized reregulation. The definition of these types is shown in the following table.

	State goals	State-industry relations	Methods of state control
Expansionary	Strategic	Enhance	Reregulation
Strategic	Strategic	Enhance	Reregulation
Subordinated	Laissez-faire	Retain	Liberalization
Decentralized	Laissez-faire	Undermine	Liberalization

## **(4) Strategic value logic: how state control varies**

(a) Strategic value across sectors

The strategic value of a sector is the key factor that shapes how the central government formulates state goals, who controls FDI policy, and what kinds of measures are employed towards this sector. The degree of strategic value has political and economic dimensions. On the political dimension it is defined by a sector's importance to national security, broadly defined, including political and social stability, environmental security, and foreign relations. On the economic dimension strategic value is defined by a sector's value input in the country's technological and infrastructural base and the importance and contribution of a given sector to the competitiveness of other sectors and the rest of the economy.

(b) Change across time: a phase of reregulation follows a phase of liberalization

An examination of change across time in each sector reveals that a logical link exists between a phase of liberalization and a phase of reregulation of FDI. The state reregulates either to reap the rewards of liberalization or to compensate for administrative and institutional weakness as a result of liberalization. Though each sector follows its own pattern, reregulatory efforts roughly coincide with nation-wide administrative restructuring, which has occurred in five-year increments, in 1988, 1993, 1998, 2003, and 2008. Two factors explain variation across time. One is domestic sector's competitive position, the other is the organization of state institutions.

(c) China's participation in bilateral and multilateral trade regimes

Inflows of FDI into China have increased enormously between 1980 and 2006. Many scholars think that bilateral and multilateral pressure to liberalize has been the decisive factor that pushes Chinese government to conduct economic and political reform, including the liberalization of FDI. Indeed, China's participation in multilateral, regional, and bilateral arrangements such as WTO obligated China to liberalized trade and FDI. But these arguments cannot explain the variation in degree and nature of reregulation across sectors.

(d) Political fragmentation and federalism, Chinese style.

The fragmented and decentralized context underlying China's economic reforms explain in part the nature of state control of FDI. How state control varies across sectors, however, reveals that fragmentation and decentralization do not explain the full story. It is true that in some sectors the government has limited role, but there are areas that the government still retains strong holds.

(e) Proliferation of foreign actors

The emergence of China's bifurcated strategy toward FDI occurs in a context of emerging non-state, domestic, and international interests introduced by three decades of economic reforms. Despite the presence of these, their influence has been limited. The increasing number of non-state actors has not prevented the state to reregulate to enhance its control to achieve its sectorial goals.

(f) Sector-specific requirements

Industrial sectors' difference in technological characteristics and capital requirements can in part explain why state control of FDI varies across industries. But this understanding is insufficient because it falls short in explaining the variations in state control across subsectors and across time.

**(5) Case studies: textile and telecommunication industries**

With the strategic value framework, I analyze the state control in two industries. The industry of telecommunication has high strategic value and the government deliberately reinforced the state control in this industry. Since the strategic value is lower, the government governs textile industry with decentralized engagement. The analysis is summarized in the next table.

	Telecommunications	Textiles
Dominant pattern of state control	Strategic reinforcement	Decentralized engagement
State goals	Modernization of networks	Local goals: maximization of employment, FDI, tax revenue
	Control of information	
	Control of technology	Foreign economic relations
State-industry relations	Enhance central government control	Undermine central government control
State methods	Sector-specific rules and regulations, and technical standards that impede market entry	Macro-economic policies
		Local rules and regulations that impede local market access

In the larger study, I also examined how state control varies in other strategic (financial services, energy and automobiles) and non-strategic industries (food stuffs, paper, and consumer electronics).

**4. Discussions**

**Stephany Griffith-Jones:**

Your comment on Latin American countries is a bit simplistic. The Latin Americans did try to regulate FDI along the lines of East Asia for a period. To what extent does China use the East Asian model?

**Roselyn Hsueh:**

Among Latin American countries there are a lot of variations, even in Asian countries. There were variations among their development themes. You are right in that there are times where the government has attempted to structure FDI. I didn't have time to go into development trajectory of these industries. In 1993 the government broke grounds and allowed FDI to enter telecom industry despite existent FDI prohibitions. The government worked with provincial branches of these companies to develop 3G networks. In 1998, right before WTO session, they actually forced divestment of FDI. The rationale for that is we have rules against FDI, you came in on your own and we can't help you. The foreign

government refused to step in, but certain lobbying powers were more powerful than others. So AT&T and Qualcomm could still do business in China during rounds of WTO negotiations for China's entry into the WTO.

**Carl Riskin:**

How should the government evaluate the strategic value of sectors? What sectors they ought to be devoting attention to? What sectors can they ignore?

**Joseph Stiglitz:**

When you think about the word "strategic", there are a number of things that occur. One is externality of technology. Second, telecommunication industry has been a huge source of rents in many countries, so if I can control, I can make lots of money. I just want to make sure that I get the rents, rather than somebody abroad. So rent-seeking is part of story. Third, some sectors are very difficult to control. Like textile industry, there's no way I can control that due to small producers that are very difficult to control. But the nature of telecoms is that there're a limited number of players so it is easy to control. So it becomes if I can control them I'll call them strategic.

**Roselyn Hsueh:**

The nature of sector matters. But it's found that telecommunication sector in a lot of countries has been deregulated. China has gone in the other direction and reinforced its control. Traditionally, around the world, services are regulated while equipments are not, but the Chinese government has merged regulating these two types. To achieve some of the political goals (control of information, e.g.), it has gone against the trend. The nature matters, but there are interesting ways the government has structured their moves. Textiles sector is very decentralized, but if the local government has intervened it is to promote Chinese brand marketers for the internal and international markets. Comparing it to other countries, subjective interpretation of strategic values certainly matters. I am extending my study to India, it is a completely different picture in terms of telecoms, which is completely liberalized. The idea of controlling information might not be an important goal. India government has been much more protective of its equipment sector and has come up with all sorts of rules to limit market access. I am still trying to figure out.

**Carl Riskin:**

How about automobile industry?

**Roselyn Hsueh:**

It is a mixed picture. It is not national security concern, but does feed into technological concern. There are all sorts of rules limiting imports of entire automobile assembly kits, and they're also limiting foreign access to automobile markets by ensuring that foreign players must enter into local enterprises. But the central government relinquished some control to local governments.

**Ye Qi:**

Two questions. One, you're comparing telecom and textile, but the two industries are so different. In telecom, there are large state-owned companies, even tight control for private domestic investment in that sector, not just FDI. You're comparing two very different industries and drawing conclusions from that. Treating the two must be very different as well. The second question is about the validity of information control as political goal here. Let's compare telecom and website, which is more sensitive in control of information, but you see a lot of FDI in those website companies. If we use your hypothesis, we would have tighter controls in these companies.

**Joseph Stiglitz:**

In the US, a very competitive market, if the government wants to wiretap everyone the companies have to comply. Now matter what the structure is.

**Roselyn Hsueh:**

In 1980s, textile is much more centralized than telecom which is very decentralized. But they went in the opposite direction. About argument in the US, the government has discretion and has, in some ways, exercised that. In liberal economic settings we see these manifestations happening.

## **Session IX. Regulatory Structures and Political Economy**

Main Speakers: Akbar Noman; Xiaobing Wang; Zhiyuan Cui; Roy Prosterman

### **1. Akbar Noman: Regulations and Incentives: Conflict and Compatibility**

I will talk about some general issue of regulatory system which has been ignored in regulatory practice. Should regulation be applied to outcomes or actions of people without worrying about their incentives? This question has been neglected in the U.S. and elsewhere partly because they don't want to interfere with the market. There are two dimensions about regulations and incentives. One is the compatibility of regulations and incentive structures and regulations are likely to be ineffective where there are strong incentives to violate or get around them. The other is regulation of incentives in order to address the principle-agent problems inherent in firms. There is increasing concern about the explosive rise in compensation packages of CEOs and senior management. Aside from the astonishing absolute levels to which compensation packages have shot up, the concern reflects the very poor link between reward and risk and reward and performance in general.

In Europe, the problem is less acute and subject to more regulations than in the US. UK has progressive taxation which makes the problem less serious. The case for China to pay special attention to incentives embedded in compensation packages in reforming its regulatory regime is made more important by the emphasis on "harmonious development". In the context of rising inequality in income in China, the issue about compensation schemes has come to the fore. By and large, CEOs' compensation has been something that has not been subjected to regulation in China.

Compensation should be regulated and should receive more attention in US and elsewhere. This is particularly needed in financial sector, stemming from the poor link between risks and rewards. Many bankers made big fortunes from making loans to Latin American countries in the 1970s or to East Asian economies in the 1980s without paying any price for the subsequent financial crises that resulted from their risk-taking. The problem has become more acute with the deregulation of financial markets and the consequent proliferation of complex securities. The traders selling these securities had little or incentive to worry about the risks while collecting fortunes from devising and selling them. Of course, finance is the most dramatic area but not the only area where such incompatibilities arise.

Then what are the options for regulating these compensation incentives? One that seems to have clear and probably universal application is restricting stock options. There are complex and difficult issues need to be examined. What should be the threshold of the level of compensation? We can also think about the types of compensation and what they are awarded for. But the timing of when the options can be exercised is the most compelling aspect. The basic idea is that those who receive stock options should be restricted to exercising their options after a decent interval of time, when the consequences of their actions have time to come out.



There's a question of conflicts of interests which needs more research within the context of regulation. Rating agencies are part of the problem in the current financial crisis. Joe thinks it's more incompetence than incentives that was behind their performance. But I think incentives were more relevant. When the rating agencies were dependent on the issuers of those securities, they had strong incentives to overlook the risks inherent in these securities.

My hypothesis is that this hasn't received adequate attention in regulatory regimes in different types of capitalism. So when China thinks about copying other regimes, it needs to think if there are other capitalisms that have done a better job, including solving regulatory capture problem. Because of dualism, fragmentation, and party-state issues in China's system, China needs to be very careful to think about how to regulate incentive structures to design China's regulatory regime with Chinese characteristics. Need to explore options of regulation of incentives.

## **2. Discussions**

### **Joseph Stiglitz:**

Is there much discussion of particular issue of compensation and then incentives embedded in that in China?

### **Athar Hussain:**

There is agency which is responsible for ownership rights. It did ban stock option for the last 2-3 years. This affected mostly state-owned enterprises.

### **Roselyn Hsueh:**

There are other methods, including state mandated personnel changes, to decrease vested interests and to lower risk taking. Such examples exist in those publicly listed telecom carriers.

### **Fang Lee Cooke:**

This can go the other way because CEOs may focus on short-term rather than long-term returns.

### **Joseph Stiglitz:**

The concern with stock options is that stock options are not really performance related. There are other forms of compensation so stock options are total charade. In terms of action, disclosure should be the minimal requirement. Taxes are important for stock options because stock options are thought to be tax preferred. But if you look at it more closely, it turns out that it is not tax-preferred. With stock option, money is transferred from company to individuals. But the costs to the corporation and the benefits to the shareholder are not exempted by tax. So using stock option is a tax inefficient way of compensating managers. But the corporations do not care about that. They are more interested in stealing money from share holders. So, using tax to regulate this is actually not going to work here.

There is incentive compatibility problem with any regulation. Because by definitely regulation is trying to get people to change the way they behave. So we need to regulate the arbitrage between the costs and benefits of regulation. People are trying to circumvent the regulation. You can make it more difficult to circumvent. But you have to realize that these guys are very clever at circumventing regulation. That's one of the reasons why I feel quite pessimistic about this. You need a whole army of measures. You have to try to tie their hands as much as you can.

**Akbar Noman:**

It should be made part of the regulatory regimes to make sure that incentive regimes are manipulated in such a way that they cannot circumvent the regulation.

**Joseph Stiglitz:**

Look at the lawyers who are hired for circumventing regulation and get them to try to restrict/outsmart those who try to get around the law.

**Stephany Griffith-Jones:**

The whole issue of stock options should be reconsidered.

**Joseph Stiglitz:**

You can create another system that is basically like stock option, i.e. compensation will be dependent on the performance of the stock. Then you hope CEOs will work harder for long-term benefits. But unless you put it in a particular tight way, you will have the same problem as stock options. Stock option is not totally transparent and that's why the firms like it. The firms don't have to have high cash flows to do this. Most cases firms use it for non-transparency.

### **3. Xiaobing Wang: Regulation and Corruption in China**

I will present a certain type of relationship between regulation and corruption and analyze how they can be related to economic growth. There is a conventional view that both poor institutions and high level of corruption hinder growth. However, in many Southeast Asian countries including China, their institutions are not well developed, the corruption levels are high, but they are among the fastest growing economies. The missing link is the interaction between regulation and corruption.

#### **(1) State capacity and development**

State capacity is correlated with the level of development. When state capacity is low, it tends to have either less good regulations needed to support the market or too many bad regulations that hinder market development. This constrains economic activities. It's the central government and some of the provincial governments that originate laws policies and regulations. But local government officials are those who implement these laws and regulations. In the case of bad regulations, if they are fully implemented they will hinder growth. It's better not to implement them if they are bad.

## **(2) China's regulations**

In China and many other transitional economies, their economic institutions and regulations were created for planned economy and public ownership. These laws and regulations may actually be obstacles to the functions of market. These inherited laws should be reformed, but because state capacity is low, it takes time for these laws and regulations to be reformed. There is a big time lag.

Here are some examples of China's bad regulations: restrictions of entry by private sector, restrictions of firm size, and restrictions of certain economic activities. For instance, buying at a lower price and selling at a higher price, the now normal business practices, was a criminal offence (Touji Daoba). These regulations constrain economic activities.

## **(3) The role of corruption**

How did China grow despite these problems? Corruption can actually keep those bad policies from being fully implemented and thus support growth. That is, corruption is a way to escape bad regulations; it enables people to break the status quo at the time when institutions are bad. This kind of corruption is not as any hindrance to the economy, but as a convenient device for overcoming regulatory hurdles that distort incentives and opportunities.

How was corruption possible? Decentralized political structure gives officials the power to implement or not to implement certain policies on certain firms and individuals and no public power can affect the promotion of an official. This makes corruption less likely to be caught and so makes corruption popular and less risky.

There is some evidence on the role of corruption. Over the past 25 years, private sector grows much faster than others and provides most of economy's growth. This partly because private sector has incentives to bribery and get things done, while the state sector sticks to the law and do not bother the performance.

When china develops, state capacity including china's intellectual capacity increases, and China is able to reduce its bad policies and regulations. With the decrease of the proportion of bad regulations, the proportion of good corruption also decreases and the proportion of bad corruption increases.

## **(4) Policy implications**

I want to clarify that I am not encouraging corruption but rather provide some justifications on observations. The second best is the best when there is no first best. You can't change bad regulations because state has low capacity at low level of development. Therefore, being too tough on corruption at early stage of development could kill potential development. But being not serious about corruption at later stage of development could also stagnate development. Limited resources such as aid should be used

to increase state capacity rather than largely on curbing corruption at early stage of development.

#### **4. Discussions**

**Akbar Norman:**

Is that something that Deng actually said?

**Xiaobing Wang:**

Examples are given by Deng.

**Carl Riskin:**

You open the window, then flies come in?

**Xiaobing Wang:**

Deng said, we should put this aside for a while. He said it implicitly.

**Xifang Sun:**

One concern is the dynamics of the relationship between regulation and corruption. Is there really “good” corruption? “Bad” regulations and ‘good’ corruption will create vested interest groups which will hinder the development of “good” regulations. How do you think about this issue?

**Xiaobing Wang:**

It’s true that corruption leads to more bad regulations in Latin America. To prevent further collusion, the central government needs to exercise its power to create better regulation. In China, the central government has most power and local government officials have no power to change the regulation anyway so engaging in good corruption is a good substitute for now.

**Akbar Noman:**

It is a hard to draw a line between good corruption and bad corruption.

**Fang Lee Cooke:**

You mentioned the constraint of size in terms of number of employees as an example of bad regulation. It is not necessarily bad regulation and it’s used elsewhere as well. EU adopted the same criteria. This is a way to help business to grow and create employment. Firms don’t want to grow bigger because they will be subject to more taxation.

**James Galbraith:**

From a historical perspective, regulation and arbitrage are not issues. You said arbitrage is a bad corruption. In 1942-1945 there was widespread rationing for good purposes. After the war that rationing had to be accompanied with black market.

**Joseph Stiglitz:**

You have a set of regulation appropriate in one world, but you have another set of regulations in another world.

**James Galbraith:**

I don't know why the state did not just lift the food price control.

**Xiaobing Wang:**

Because the state doesn't have enough intellectual capacity to do that.

**Heping Cao:**

When we talk about corruption we mean completely bad things. Corruption is not an economic choice. You should define your corruption very clearly. You cannot use statistical meaning to supplement the original philosophical meaning.

**Joseph Stiglitz:**

The instrumental index of corruption in Asia is high. There is a problem when you try to define precisely what corruption is. In US and more advanced societies, the magnitudes are actually larger than in China, like political campaigns or lobby. But nobody calls it corruption but it is corruption. Some of the discussion about corruption in developing countries is that you haven't developed a sophisticated form of corruption yet. Whenever there is a principal-agent problem, when the agents are not doing what they are supposed to do, there is corruption. I am not sure the vocabulary of "corruption" is the right way to describe corruption in china. We have to be careful using the word "corruption". America is more corrupted in some sense (different words).

**Jianyue Xu:**

In economic area it is hard to say what is good law or bad law. Until 1956, China gave power to the capitalist class, who tried to use their power to disturb the economy. So the government created the new laws to limit their power.

**5. Cui Zhiyuan: Land Regulation in China---A Perspective from Henry George**

I choose this topic trying to understand what is so special about Chinese reform and development. Many people in china don't consider that China's approach to reform is different from Washington Consensus. If so then what China is doing is not so special then. In China, people always say "Chinese characteristics" but they are not sure what it means by this. I am trying to pin down what is so special about Chinese reform approach. Let me tell you a personal experience. Russia is actually largely privatized. When I was in Moscow, Russia, I had a bad experience at the airport. From Terminal 2 to terminal 3, I have to take bus. But the bus was delayed for an hour. The airports in Moscow or St. Petersburg cannot be comparable with any airport in China. So what is special of China? China has much better infrastructure. Russia has conducted a lot of privatization reforms! So is market reform really a

good thing? I want to apply this question to land regulation.

The rapid development in China is not financed by the government budget but from the Henry George type revenue, i.e. value increase in land price captured through public ownership of land. This partially reflects “Henry George Theorem”: “In a simple spatial economy, where the spatial concentration of economic activity is due to a pure local public good and where population size is optimal, aggregate land rents equal expenditure on the pure public good. This result has been dubbed the Henry George Theorem, since a confiscatory tax on land rents is not only efficient, it is also the ‘single tax’ necessary to finance the pure public good.”

Henry George’s idea has been very influential in China. Dr. Sun Yat-Sen, a good friend of Henry George, tried to design mechanism to implement land value tax, the annual tax on the market rental value of the land in China. The basic idea was to try to capture land value increase.

Henry George Theorem is very relevant in explaining China’s fast development. Because of public land ownership, China government is able to finance the local infrastructure by capturing land value other than using other type of tax. Shanghai Pudong’s development history is an example. Very little central government budget was invested in developing Pudong. As Qizheng Zhao, the deputy mayor of Shanghai, put it, “the logic of Pudong” is “using public land ownership to absorb new investment capital, which will increase the land value, and the government will be able to capture this land value increase partly and reinvest it to develop the land further.”

This table shows that revenues from land leasing have been a substantial part of total revenues for local governments. So what’s special in China is the public ownership of land, through which and some smart mechanism design the local governments can capture land value increase and use this revenue for infrastructural investments. This example of socialist market economy means that public ownership through some mechanism design will lead to some good market results. The current proposal of introducing real estate tax in China is different from Henry George’s land value tax (LVT) but similar to the “council tax” in the UK.

## **6. Discussions**

### **Xifang Sun:**

The development model you described is characterized by public land ownership and public investment. An alternative model of development is that the land is owned privately and private owners receive higher rents from land value increase and then they can use the rents for investment. The issue is which is the more efficient way, public and private investments?

### **Zhiyuan Cui:**

Land value increase is not due to private investment.

**Joseph Stiglitz:**

The standard argument for private land control is that private owners have incentives to make sure that the land is used more efficiently and to improve the conditions of the land. The question is that clearly some increase of land value is caused by the improved conditions of the land. The problem of the Henry George Theorem is it is hard to really distinguish between the increased land value and improvements of the land.

**Zhiyuan Cui:**

I have no answers. But I think we can try. Since 2005, land value tax reform commission has been trying to distinguish between the two things.

**Qixuan Huang:**

As we know land value in big cities may increase than rural places. Then the urban places may have more resources to finance infrastructure. Will this increase disparity between big cities and rural areas?

**Zhiyuan Cui:**

The idea is to try to understand what is special about the social capitalism system in China. This policy wouldn't solve income disparity problem.

**Heping Cao:**

“Science and Technology Park” is another example. Since 1998, all cities have been trying to divide up land to establish Science and Technology Parks. After announcement of these programs the land prices usually went up significantly.

**Roy Prosterman:**

I have looked at Henry George's theory in the context of Soviet Union, and concluded that it wasn't a very good idea. Agricultural tax has been applied to some jurisdictions of US but forced people out of agriculture. With the food price crisis, China should try to be in the position to feed itself. Taxation on land would cause great concerns.

**Zhiyuan Cui:**

This is only a proposal. I am not supporting it. Henry George was focusing on land value not house value.

**Heping Cao:**

You are trying to argue that public land ownership is the socialistic characteristics of Chinese economy. I see it as an issue of vested interests.

**James Galbraith:**

One form in US using land very well is university land.

**Xianbing Wang:**

Public ownership of land will increase efficiency only if we assume that the government uses land wisely.

**Joseph Stiglitz:**

The point of George's theorem is that it will work if we could identify "pure rent" with no distortion. But in practice you can't identify the pure rent. The result of that is there may be some distortion whereby people don't take into account the appropriate value.

**James Galbraith:**

It is not about efficiency. It is about public access. This is why infrastructure is so good in China and not in Russia.

## **7. Roy Prosterman: How is Full Private Ownership of Land Possible in China?**

More than half of the population in China are still in the agricultural sector. There are a number of measures of inequality. Rural sector has more child mortality and low life expectancy. The ratio of urban to rural per capita income was 3.3: 1 at the end of 2007.

After coming to power in 1949, the Communist Party's initial reform gave farmers full, individual private ownership of their small farms through the 1950 Land Reform Law and other regulations. Seven years later, the government started to bring about collectivization of all farming land in 1956, but which turned out to be a disastrous process of land ownership law reform. Then the Chinese land tenure moved to household responsibility system giving individuals partial right of land, which started in 1979 and was completed in 1984. When they did have private ownership of land, the farm income was increased by 75%. In 2002, the government adopted the Rural Land Contracting Law (RLCL), which aims at strengthening the legal regime for farmers' thirty-year rights to land. But the law has not been effectively implemented. No more than 40% of the villages have implemented this long-term right.

This year, there has been a substantial development for private land ownership. If Chinese farmers were to be given full private ownership of their land, what measures might contribute to this being most confidently and successfully done? Is there a safe-guard so that farmers don't lose their ownership?

Two things should be mentioned. One is legal restrictions. Do not allow sale, or even lease, of land rights to anyone who would not be a directly self-cultivating farmer. Such a restriction might be applied for an initial period. An alternative to restrictions on sale of land is to tax the capital gain from land transfer after you've held and cultivated for a number of years. If you try to sell earlier then you'll be taxed heavily. Farmers as owners should be able to capture the value of their land if the land becomes saleable. But taxation of profits from such transfers could be at a high percentage rate. There could also be restrictions tailored to specific geographical regions and land types that specify the maximum ceiling on how much land that can be accumulated. There might be a prohibition of any purchase or lease of agricultural land by foreign people. The more of these restrictions you pile on, the more you undercut the full benefit of



private ownership. Should there be a formal land registry is another issue. But there would need to be enough publicity for these rights. Farmers have lack of knowledge of their rights to own these lands. There need to be active monitoring systems, surveys, hotline surveys facilitated by technology like cell phones, etc.

## **8. Discussions**

### **Carl Riskin:**

Do you think full privatization will be impediment to development?

### **Joseph Stiglitz:**

Who is agitating for private land ownership? Are they small farmers or big owners?

### **Roy Prosterman:**

It seems to be small farmers. seems to be quite grass-root.

### **James Galbraith:**

Do you think it is a part of social security problem?

### **Roy Prosterman:**

One element of compensation should be related to social security.

### **Carl Riskin:**

After a year or two if they sell land and become jobless then it will create more problems.

### **Roy Prosterman:**

You still lose the land. But if there is a contract then you are made sure to be compensated at a deserved price. Property law states that one element of compensation should be social security. They also introduce a general principal that the farmers should be able to reproduce the stream of income.

### **Joseph Stiglitz:**

Part of the problem is with social security. In India, many people mortgage their land to pay for medicine, education, for example. But if you don't have good social insurance, you can't mortgage your land. Otherwise you will lose your land if you have one bad year.

### **Athar Hussain:**

The main issue is about not ownership but compensation. People who want to move out of land are supporting private ownership but people who want to stay on the land are more supportive of collective ownership. Maybe full property right is not the answer.

### **Roy Prosterman:**

This is not a presentation for arguing that the private ownership is the way to go. I still believe in full implementation of long-term land rights. The counter-argument is the psychological one, i.e. to tell farmers that they are now the private “owner”, and then to give them incentives to stand up for their rights. Collective ownership is ownership for all the members of the village.

**Athar Hussain:**

One issue is about the “Land Bank”, local governments use it as collateral to get loan from the banks.

**Roy Prosterman:**

Mortgage is not legal for arable land.

## **Session X. The Dialectics of Law and Development**

Main Speakers: Antara Haldar; Joseph E. Stiglitz

### **1. Antara Haldar: The Analytics of Formality and Informality**

#### **(1) Two credit programs**

There is an ongoing debate with regard to the type of law that is needed to stimulate development. The traditional emphasis has been on formal law, especially by Austrian and Chicago schools. But this accepted wisdom is not justifiable. We revisit this debate by comparing two programs, Yunus's Grameen Bank and the program advocated by De Soto. Both programs try to provide access to credit to the poor, but De Soto program works through legal formalization and Grameen Bank through informal trust-based peer-monitoring networks.

We will compare the performance of the Yunus program and the De Soto scheme in terms of their efficiency and equity effects. There are 4 central questions: (a) Has De Soto been able to overcome the problems of formal legal reform in the developing world? (b) If not, can a case be made for informal, community-based regulation? (c) Are informality and formality complements or substitutes? (d) Can the gap between the two be bridged?

#### **(2) Efficiency effects**

We use the contractual model to compare the efficiency effects of the two models. There are two types of problems: contract design and contract enforcement.

##### **(a) Efficiency of De Soto program**

The design innovation of the De Soto model is the attempt to use collateral to overcome the contracting problem. In "enforcement" terms, De Soto adopts external enforcement model via State legal system. With regard to the "enforcement" of contracts, the problem is that the promise of enforcement is not credible because of higher information costs, limited legal capacity, legitimacy difficulty, increased uncertainty, etc.

##### **(b) Efficiency of Yunus model**

The design of the contract in the Yunus Model is characterized by the absence of formal barriers to entry into the contract. There is not collateral requirement and no legal contract between the Bank and the borrower. And the contract is enforced via mutual enforcement model or pro-social disposition model. In "design" terms, the Yunus model is very effective in inducing entry into the credit contract. In terms of "enforcement", this model has significant advantages. The enforcement process involves lower information costs and the threat of enforcement is credible.

### **(3) Equity effects**

Let's now turn to the equity benefits of the two programs. We consider the impact of both programs on economic variables like income, investment, employment, and property ownership, as well as welfare indices like gender equity, access to education, access to healthcare, and so on.

#### **(a) Equity effects of De Soto program**

The De Soto program does not directly address welfare indices of inherent value, but rather attempt to address these indices indirectly via economic variables. In terms of economic variables, the evidence is mixed. On the positive side, the program has increased formal property ownership. There is evidence that titling leads to increased household investment and increase in labor force participations rates. But the validity of these results has been brought into question. On the negative side, the program involves potential threat of landlessness, and throws up the problem of inequities of initial access to land.

#### **(b) Equity effects of Yunus program**

The Yunus program focuses both on economic and welfare variables. There are studies showing that participation in Grameen program leads to increased household income and reduced poverty. The program also provides assistance in acquiring business assets and employment means generating activities. The Yunus program is considered to make a significant contribution to gender equity.

### **(3) Dynamic analysis**

De Soto model relies on formal institutions such as a system of law for design and enforcement. With a view of market as imperfect, the Yunus model tries to harness existent social capital to achieve efficiency and equity. But even more significantly, the Yunus model's benefits may go beyond static gains to dynamic gains. It may pave the way for the transition from the personalized informal regulation restricted to limited networks to the impersonal formal system by building up a norm of trust. On this analysis, informality is not replacing formality completely. Formality and informality turn out to be complementary rather than competing options.

### **(4) Conclusions**

These are undoubtedly significant merits to formal legal systems, as well as well defined property rights. But a well-functioning formal legal system cannot be achieved over-night. In the interim, informal regulation structures have significant advantages. Their success may be due to the different view that they take it development seeing it as a process rather than an end result.

## **2. Discussions**

**Xifang Sun:**

I am curious about the Yunus model. The Grameen Bank is a huge bank. Transaction costs between the bank and its borrowers are very high. How are the staff monitored and evaluated within such a big bank, especially in local areas?

**Joseph Stiglitz:**

They use a “star system” to evaluate. Percy Barnevik’ micro credit system has a school system, but one of their problems is that teachers don’t show up. So what they did was to establish motorcycle inspector at random. Penalty was very severe. The question of individual incentive was very much undermined. What is true is that Grameen and Barnevik are very decentralized networks. It’s almost like social movements. A branch establishes sub-branches, so they have a lot of autonomy to give themselves capability to monitor. Another mechanism is the repayment rate. Lending and payment are not separate. You need some performance indicator. There is no connection between those who give loans and who collect loans in the US, but in Grameen those two are closely linked.

**Carl Riskin:**

There is a big debate over that Grameen bank should not be managed on profit-based. What is your comment?

**Joseph Stiglitz:**

One of the points that we raise is that Grameen is successful in Bangladesh because it has created social capital that makes it less necessary to use formal institutions. I worry a great deal about the transplanting of micro credit without social capital. The second point, micro-credit movement in Bangladesh has good leaders who are able to adapt but when it gets transplanted it might not be as successful. There won’t be adaptation.

**James Galbraith:**

I worry about it as well. Neither model addresses the effectiveness of financial structure. Grameen has little to say about conditions of the workers.

**Joseph Stiglitz:**

This is only a small part of development strategy. What De Soto tried to say is that this is the solution to development problem. But I think it is only part of it. It doesn’t create enterprises. There is under utilized labor in household. It provides a channel that such labor can be utilized but it doesn’t create new enterprises. It is very important as a precondition for development but it’s not solution for development. People may overestimate the micro-credit programs. The transaction cost in Grameen is very high. Even with 97% repayment rate, until recently Gramin ran a loss, it couldn’t capture all the transaction cost. Since 1998, it’s moved from peer monitoring to more reputation base, but it’s not formal contract based. I want to give this talk here because there is a discussion about micro-credit in China.

**Roy Prosterman:**

De Soto model is more situational intervention. Documentations have been helpful in land evaluation.

**Joseph Stiglitz:**

That process of documentation itself is creating inequality.

**Athar Hussain:**

Looking at micro-credit, there are a high proportion of women initially, but at the end left with proportion of women who are quite difficult. As time goes by, their ability to organize themselves actually decreases. The punch line of this paper is to look at how these two frameworks can be generalized to other countries. Look at what works and what doesn't work.

## **Session XI. Inequality and Social Welfare Regulation**

Main speakers: James Galbraith; Carl Riskin; Qin Gao; Ling Li; Jin-Yeu Tsou

### **1. James Galbraith: The Beijing Bubble---Inequality, Trade, and Capital Inflow into China**

We try to interpret the Chinese development model in a broader term. What's China? It has a long history. Is it becoming a Western country? Is it taking the capitalist road and marching forward into globalization? Or is China following the "Asian model"? Are there any lingering effects of the Revolution and a long period of Socialist Construction?

The thesis of our presentation is that China is undergoing financialization with effects on distribution of income that are similar to financialization everywhere else.

This figure shows China's inequality measurement which uses payroll data based on the official Yearbook. Inequality has been rising from 1987 to 2006. In 1990s overall inequality was rising. After 2001 inequality within provinces is still rising, but inequality between provinces has started to decline. The second figure shows contributions of provinces to total inequality in China from 1987 to 2006. Much of the rise could be attributed to Beijing, Shanghai, and Guangdong. The enormous relative contribution of Guangdong peaked at 1994 and that of Shanghai around 2000 although there was enormous export increase after 2001. After 2001 the relative contribution of Beijing has continued to rise. This reflects the acceleration of urban reconstruction and a speculative building boom in Beijing. We should also look at employment of export provinces. We found that there are about 5 million jobs increased in manufacturing sectors in the major export provinces while the loss in other provinces is 1.5 million.

This table presents the current account during 1998-2005. There was a puzzling increase in export and surpluses during the turn of this decade. Look at the increase of unit values, those numbers are from OECD. A very large fraction of the gains in reported Chinese exports after 2002 is apparently due to rapidly rising unit values; only 40% of the export rise can be firmly attributed to rising export quantities. But increase in unit price of imports from China in EU has not been substantial. Look at the employment structure in China. There is a continuous upgrading but there is no acceleration in the composition of imports from China. There is difference in profitability between the internal market and export. It is the case that one can make more money by going to export market. There is enormous increase in profitability for export companies. Then Chinese exporters have been over-reporting export prices to the Chinese authorities, for the purpose of bring foreign capital into the country.

Therefore, we suggest that a major source of capital inflow into China is simply the extra-normal profits associated with selling to the external market.

Look at the relative balance of income across sectors. Banking sector has become more important.

Finance is the biggest contributor of inequality of income in China. Profits from export boom have been channeled to financial activities in China.

## **2. Discussions**

**Carl Riskin:**

Did you look into the role of “Processing Export”?

**James Galbraith:**

We did look at. But there was no sign. First, we look at whether the share of processing export is rising; second, whether there is a corresponding rise in import price. But we found nothing.

**Joseph Stiglitz:**

Do you have a hypothesis why there was a rise of profits but the money didn't go to workers?

**James Galbraith:**

I can imagine why the money cannot go to workers. Workers are temporary. They come, work and go.

**Carl Riskin:**

Why did you call this investment speculative?

**James Galbraith:**

Because the money goes to real estate sector.

**Joseph Stiglitz:**

Some of profits are reinvested into manufacture. But the most of them go into real estate. What should the Chinese government do?

**Liqing Zhang:**

Do you think profits in export sector are much higher than that in manufacturing sector and non-tradable sector?

**James Galbraith:**

I would distinguish between sectors with substantial monopoly power, such as sectors like financial services, and agriculture.

**Liqing Zhang:**

If profits of export sector are much higher than other sectors, the currency appreciation would be more beneficial because they have excess profit.

**Joseph Stiglitz:**



If the bubble is existing, currency appreciation will burst the real estate bubble.

**James Galbraith:**

If currency is appreciated abruptly, people who brought money in will suffer a lot. Major fall will occur in financial market bubble.

**Heping Cao:**

What the bubble exactly means? Financial or construction?

**James Galbraith:**

What happens on overbuilding or building boom.

**Joseph Stiglitz:**

In the case of real-estate bubble in the US, it is obvious when there is a financial unraveling that would lead to economic slow-down. Banking system was recapitalized. Should the Chinese government recapitalize banking system?

**James Galbraith:**

The hit would be most heavy on the municipal government.

**Athar Hussain:**

That is not the case. There are two types of buildings: residential and office buildings. James' argument would be applied to office buildings more than residential buildings. Employment in manufacturing sector has been decreasing. All evidences suggest that overall productivity increases rapidly.

**Jin-Yeu Tsou:**

There is an environment problem.

**Unrecognized participant:**

There is pressure to move manufacturing sectors from Guangdong into interior land. But it will cause social problems.

**Fang Lee Cooke:**

There is already the migrant workers shortage problem in the coastal provinces.

**Liqing Zhang:**

What is the effect of the new Labor Law? Some people believe the introduction of Labor Law will increase the costs of export and reduce the profit rate. New leaders strongly supported this law.

**James Galbraith:**

I haven't looked at that.

**Athar Hussain:**

There are implementing issues.

### **3. Carl Riskin and Qin Gao: Generosity and Participation---Variations in Urban China's MLSA Policy**

There are differences among different cities in Minimal Livelihood Standard Assistance policy (MLSA), the Debao line. Our goal is to look at the trends and variations in different cities in the level of Debao lines and to explore the factors that influence the level of generosity of cities and the level of participation. The MLSA program only covers official local residents but does not cover migrants who are substantial proportion of the urban population.

We use two datasets. Microdata come from China Household Income Project (CHIP) 2002 Urban Sample; the macrodata cover a sample of 35 large cities. Target variables are MLSA lines and MLSA participation rates. City economic indicators include per capita disposable income, GDP growth rate, unemployment rate, and Engel index. MLSA generosity is measured by city MLSA assistance lines (from Ministry. of Civil Affairs).

#### **(1) Trends and variations in MLSA lines and participation rate**

Figure 1 shows total MLSA expenditures and the number of recipients in urban China from 1996 to 2007. Both MLSA expenditures and number of recipients have increased rapidly during this period. Corrected for price changes, MLSA line has been very stable, as shown in Figure 2. There exist variations in MLSA lines. Eastern regions have the highest MLSA level, the next is western cities, and the cities in central China have the lowest level of assistance line. In terms of participation rate, western cities have the highest participant rate and eastern cities have the lowest participation rate. City MLSA line is positively correlated with per capita income while participation rate negatively related to it (Figure 5 and 6).

#### **(2) Factors affecting participation rate and MLSA lines**

We use three models to examine MLSA lines. The results are quite similar. All the models have high value of R-squared, indicating that our models do a good job, explaining over 85% of the Debao lines. We can see that the coefficient of per capita income is significantly positive, province GDP growth rate is negatively related with MLSA line, provincial capital city dummy and unemployment rate are positively related with MLSA line. We also include average socio-economic characteristics. Central and Western regions tend to have lower Debao lines.

For family Debao participation rate, it turns out that it is difficult to explain the household participation

status. Our models, at most, explain no more than 25% of the variation in household participation. We find that low per capita income, bad health, unmarried, unemployment variables are positively related to Debao participation probability.

Figure 7 presents the correlation between city MLSA lines and participation rate. Cities with lower assistant line tends to have higher participation rate. There is positive relationship between city per capita income and Debao line and negative relationship between city per capita income and Debao participation rate.

### **(3) Conclusion**

MLSA participation rates in China are low. Whether we can explain it or not, it's very low. This is partly due to low urban poverty rates, which is good! But this is also partly due to the important omission of rural migrants, whose poverty rate is much higher but who are not eligible for Debao program, which is not good! And this result is also partly due to incomplete coverage of those eligible. The latter two reasons represent weakness in this safety net program.

Much of the variation of participation rate among cities and individuals is unexplained. This raise questions about the targeting and implementation issues of this program.

The variation in city MLSA lines presents less mystery than the variation in participation rate. City MLSA lines depend largely on local per capita income which stands for fiscal capacity. A few other factors, such as city Engel index, profitability of city enterprises, and central location are also relevant.

Finally, is MLSA's character as strictly a relief programme partly relevant to the participation mystery? It's not intended to enhance recipients' capacity and actually could hinder it. If someone is trying to open a business, they are immediately dropped from the programme. There is an incentive that people with any capability of self-reliance would try to stay out of the programme.

## **4. Discussions**

### **Athar Hussain:**

You should take into account how the system is financed. There are a lot of transfers from central government to local governments, which is very different across regions. More people are in poverty than household data indicates. Participation rate is distorted by policies.

### **Carl Riskin:**

Do you have poverty rate in your migrant sample?

### **Athar Hussain:**

MLSA is very helpful in education and health. It affects the income line. Some Dibao families actually

get other subsidies. Some Dibao families don't want to get out. They want to stay.

**Joseph Stiglitz:**

Can you identify the number of people whose income is under the poverty line? That is a more persuasive way to check the participation rates in this group of people.

**Athar Hussain:**

It would be interesting to know the ratio of Dibao line and poverty line.

**Heping Cao:**

If we want to measure the generosity of MLSA, we need to look at the subsistence level of consumption. The living costs in Beijing and a small city will be much different.

**Fang Lee Cooke:**

You can use the local minimum wage.

**Carl Riskin:**

Dibao is always lower than local minimum wage.

**Fang Lee Cooke:**

That is not always the case.

**Athar Hussain:**

Subsistence cost of living does matter. Dibao line is actually very low.

## **5. Ling Li: The Challenges of China's Health Care System**

The doctor and patient relationship is very tense in China. This picture shows some extreme case in Shenzhen. In another picture there is a very long line of people who are waiting to see the doctors in Beijing Tongren Hospital. An unusually harsh sentence was carried out recently to the ex-commissioner of Chinese Food and Drug regulatory Agency for taking bribes and dereliction of duty.

### **(1) Existing problems**

There are many big problems in the health care system. Costs of health care have been rising. But the government health expenditure has decreased, so the share of personal income spent on health care has increased. More and more people who should see doctors cannot afford it. There is also health inequality. Rural and urban expenditure on health care gap is huge and the gap is getting wider and wider.

**(Joe:** If you were doing the slides for US, it would be exactly the same pattern, only the number would be

different.

**Ling Li:** In China, in the past 3 years, the share of out-of-pocket was more than 52% and the share of government expenditure was only 18%. In US, the government pays about 50% of the health care cost.)

Before reform, china had achieved a lot; but after reform, Chinese health care system has not improved as well as the economy has. The Chinese health care system followed the US model, and many people including government officials believed that market would solve the health care problem. But it did not. In 1981 life expectancy was 68 years but after that the improvement slowed down. In 2000 the average life expectancy was 71 years.

**(Qin Gao:** The under-five mortality rate is very high in China. Why?

**Ling Li:** After reform, all the systems were gone. Among rural population, the mortality rate rose.)

## **(2) Health finance in China**

Overall, the health care system is composed of financing system, healthcare providers, management and regulation, equipment and drugs providers, and training and professional system. After the reform, the government let the market play the role, but then found a lot of problems. The social security system is incomplete. Out-patients had to pay out of their pockets. There is no law or regulations and employers have no incentives to pay the contribution. There is very low insurance coverage in rural areas. After 2003, the medical insurance coverage is rising but it's still low among the poor.

## **(3) The health service delivery in China**

Before reform, the health service fee was very low. The 1980s reform reduced budget support to service providers. The government only funds 8% of their budget. After reform, regulated prices are distorted with low (or negative) margin on basic care and high profit margin on high- tech care and drugs. From the structure of hospital revenue per patient, we can see that most of the hospital revenues come from medicine and medical examination. Hospital workers become drug dealers. Doctors also have strong incentives to prescribe a lot of drugs because their income depends on it. Over 10,000 new drugs enter the market each year since new drug prices are determined by the market. In one city, the mayor sold all the hospitals and claimed that he solved health care problems. I went there and found that doctors use CT scan to almost all patients.

## **(4) Management and regulation systems**

Health has a lot of special characteristics. The government has to regulate the services and makes sure that people can afford basic care. But it ended up that the doctors are pressing for high prices. But there is the issue of asymmetric information. Even the poor people choose the high price drugs because they think higher price means higher quality. So market price mechanism doesn't work in the health care field in China. There are also government failures. After reform, the government just gave up their

responsibility to ensure people's basic health care needs.

## **(5) Health care reform**

Now with new leadership the situation is changing. President Hu Jintao promises that the government will take the responsibility. A new universal health security system is being designed. Since last year, World Bank and Mckinsey are also involved in this program. To meet that goal, we need to have a comprehensive reform, to change the management and regulation structure. We need to integrate all the government departments that are involved.

## **6. Discussions**

### **Joseph Stiglitz:**

Are you thinking about moving to a single-peer system with private providers?

### **Ling Li:**

It's still a debate. The government has already promised that they will take the responsibility but now the debate is where the money should go. Should it go to the demand side or supply side? I think it should go to the national health committee. Restructuring current public hospital and health management organizations (HMO) need to combine the financing and delivery systems together. Otherwise, they will have conflicts of interests.

### **Athar Hussain:**

About the regulation, there is no national registry of people who qualify for health service. There are too many conflicts involved. Prices are determined by one organization and services are delivered by another.

### **Joseph Stiglitz:**

Is it an incentive problem?

### **Heping Cao:**

Doctors can charged nothing for their service. The government has no effective information system. Doctors' service costs less but the medicines cost a lot. So hospitals want to charge more on drugs.

### **Joseph Stiglitz:**

Do they get a kick-back on drug prices?

### **Ling Li:**

They do. It's not legal. But everyone does this and you can't punish everybody.

### **Athar Hussain:**

This is a vicious circle of bad situation. 50% of their cost is covered by drug sale.

**Qin Gao:**

Is the coverage of new system nation-wide?

**Ling Li:**

Almost national-wide. Everyone pays 15 Yuan and the government promises to give more fund, especially to local hospitals.

**Qin Gao:**

Some richer villages have experimented with pooling system in rural area.

**Ling Li:**

It is now common in rural areas.

**Carl Riskin:**

There is a possibility to design a new health care system at national level. That would be a new break-through.

**Ling Li:**

So far only urban areas are covered which only accounts for 1% of the total population. Have to do it step-by-step.

**Fang Lee Cooke:**

Even the government increases funding for hospital, the problem that the health care is too expensive may not be solved. Doctors still have incentives to charge higher fees.

**Ling Li:**

The government should increase funding and it should go to doctors.

**Joseph Stiglitz:**

Do you want to focus on the demand or supply side? Market-based system is focusing on the demand side. If you give individuals a right to choose, then you would get an efficient system. But the experience around the world shows that running such a system is expensive. You may end up spending a lot and getting very little That means we may need to concentrate on the supply side.

**Ling Li:**

Yes, that's my suggestion. The government should give more funding to the supply side and treat the doctors better.

## **7. Jin-Yeu Tsou: Challenges for the Implementation Strategy of Affordable Housing in China**

China lost a lot of land and its population has been increasing. 76% of the loss farmland was converted into built-up land during 1979-2005. China is building a new Hong Kong every year. Rapid urbanization also changes the affordability of housing. Urban housing affordability has become ever so immediate to the Chinese people as China housing was transformed from a welfare benefit to a market-driven commodity. This paper will discuss the causes of unaffordable issues of China housing from urban and housing development point of view.

### **(1) History of China urban housing development**

Before 1978, housing was a form of welfare of all urban citizens, organized and distributed by national corporations to their employees. There was a great need to improve the living condition of existing housing and to reserve the severe housing shortage problem. During 1978-1988, the state and work units significantly increased investment in public housing. The state also enforced an “open and reform” policy to commercialize housing. The private housing sector was established through the building of Commodity House and the construction of “Self-built House” by work units. 1998 saw the termination of the welfare housing system. Private housing and home-ownership, in the form of “commodity housing” and “self-built housing”, have been encouraged. In 1998, Economic Affordable House scheme as a type of Commodity House was set up. This type of housing was targeted at medium- and low-income households. Limited by the land and incentives to provide this type of housing, the supply of these houses was very limited but the market had a large demand for it.

### **(2) Composition of current housing system**

We have three types of housing currently: public, semi-private, and private. All public housing is built, funded, rented, and monitored by governments to provide housing for low-income groups. On average, these type of public housing units are smaller than the private housing. Semi-private housing is not really built by market but involves both developers and the government. These houses can only be purchased by individuals for residential use. The Economic Affordable Housing is also a semi-private type. The private housing sector consists of Commodity Housing and Private Self-Built Housing, which are built by developers and individuals and are subject to open market prices. The average price of commercialized housing has been increased greatly in recent years.

### **(3) Issues challenging housing system**

Since China is undergoing a rapid development, housing regulations and monitoring system could not catch up, especially considering the rapid urbanization process and inequality development of different areas. On one hand, the pre-mature housing market makes central and local government agencies be



involved directly, which brings difficulties in monitoring. On the other hand, developers have devoted various efforts to keep close relationship with local city officers to get high profits. They lack incentives to improve housing quality to attract potential home buyers. For the individual city residents, there is also inequality in the existing housing provision framework influenced by factors such as work unit, party relationship, income differences, “guanxi” network, etc.

(a) Government relationship with developers

An important aspect to housing is the relationship between the government and the developers through government policies and regulations. The profits of China urban estate reached 30% or even more from 1990 to 1995 and at least 20% in recent years. These profits are much higher than international average level. For such high profits raises, the housing price has increased to a level that is unaffordable to many potential home buyers.

(b) Housing and sustainable urban development

Housing estate development has become the key factors to transform Chinese cities and brought in new challenges for urban development, such as resource management, environment quality, social services, etc. Density control and land saving issues are the two key factors influencing city growth in China. Developing more city housing needs more land, which causes the reduction of farmland. This is the core problem to challenge the sustainability. House building needs to be compatible with city capacity. Implementing green architecture and eco-city planning have been defined by Beijing government as the main approaches to address the issue of sustainable development.

(c) Factors affecting the implementation of affordable housing

The current Housing Provident Fund operation (HPF) has limited the implementation of affordable housing, since the HPF is only available to the employed worker and cannot catch up with the market housing price increases. In terms of mortgage loans, banks focus on the production part of housing development and less on consumption and so banks have closer relationship to developers than to house buyers. People are still quite reluctant to be in debt in China. The Hukou system also plays a role in the housing system. Only households with permanent urban Hukou are qualified for housing provided by the city governments in most cities. There are some difficulties in providing low-income households with rental housing. Lack of interest by the city governments and lack of stable financial funding from the budget of central and local governments have slow down the implementation of low-income rental housing scheme.

#### **(4) Reference from other countries**

Hong Kong is good in terms of low-income housing management. Low rent housing is provided by the government to low income households. The Hong Kong government uses land supply policy to regulate housing prices and make housing more affordable for middle class families.

In Singapore, public housing is subsidized and built by the government for low and middle income

groups. More than 80% of Singapore people live in government built dwellings. Singapore uses social policies to ensure housing securities in conjunction with economic polices. The government runs the Central Provident Fund savings program.

## **(5) Policy implications**

The housing affordability issue does not only stem from the housing and development sector , but it is a part of the core issues within a nation's entire economy and the effectiveness of government policies. The urbanization process will continue for another 20 to 25 years and more people will move to urban areas. The pressure on providing affordable housing will be huge and will have a strong long-term impact to the sustainable development of the nation in all aspects, especially on environmental issue and land saving issue.

## **8. Discussions**

### **Joseph Stiglitz:**

There is distinction between hard regulation and soft law. In US we use mixture of incentives, large fraction goes to the profits of the developers. The soft law is that the developers won't get profits if they don't have certain proportion of affordable housing. Can you say something about hard and soft-regulation?

### **Jin-Yeu Tsou:**

Affordable housing at this moment is built in the very bad areas. There are incentives for city mayors to build affordable houses but they want to build in the bad areas. There is some negotiation scheme with possible investors but it varies case-by-case, and sometimes it doesn't work.

### **Joseph Stiglitz:**

Is that a national regulation or a local regulation?

### **Jin-Yeu Tsou:**

It is enforced by local governments. The central government will set a quota but how to provide quota of this type of housing becomes very tricky.

### **Carl Riskin:**

Low-income households are identified by income?

### **Jin-Yeu Tsou:**

Mainly based on income. How do you justify application for the low rent housing? It is actually very hard to do.

### **Athar Hussian:**

All residential buildings are now targeting for low-income people.

**Jin-Yeu Tsou:**

Architects can come up with design to circumvent the requirement.

**Xifang Sun:**

Are you aware how much land are occupied as residential land in rural areas? People in rural areas usually have larger houses. When people move to urban areas in the urbanization process, the total need for residential land in both cities and rural areas may be smaller than the current situation when most people live in rural areas.

**Jin-Yeu Tsou:**

But there are rural areas where people don't have big house. They are very poor.

**Heping Cao:**

It is not necessary to let the developers to do that. The government should do that. Otherwise, there will be a lot of bypass behaviors.

## **Session XII. Concluding Remarks and Next Steps**

### **Joseph Stiglitz:**

During these two days, we have extensive discussions on regulation issues in China. There are a number of interesting things repeated. Among them, one point is about the multiple levels of the government and how this governance structure affects the effectiveness of regulations and their implementation. Another important point is the role of formal and informal regulations. Now we turn to the last two topics, one of which is about the books and the other is about next meeting.

The idea is that we are going to put the papers from this meeting and last meeting into two books. The first volume will focus on property rights and the second one on regulation. The books will be published by Cambridge University press or Columbia university press. If you are among the one who want to submit to the books, please do it quickly. One of the problems in putting together a book is the different time in finishing the papers. We cannot provide financial incentives to do that. The first volume is focusing on the property rights; the second one is focusing on the regulation. The reference process for the first book has been going on smoothly and is at the finalizing phase now. August 1<sup>st</sup> will be the real deadline for submitting the finalized version of the papers for the first book. The deadline for the second book would be October 1st. It would be great if you keep the paper not too long since we have more good papers than the book can collect. The maximal length would be 20-30 pages with double space, or less than 7000 words. When you revise your paper, it would be great if you could echo the whole meeting and do analysis not only on issues in China but also on more general issues.

### **Carl Riskin:**

Is there anyone who will be in charge of the editorial process?

### **Joseph Stiglitz:**

Mo Ji is generally overseeing the process. Unfortunately she could not get her visa in the time of globalization. We will let you know later who will be responsible for the books.)

At the end of last meeting, there was suggestion that we should focus on regulation. It turns out to be very useful suggestions. Today what would you suggest what issues for the next meeting?

### **Fang Lee Cooke:**

Sustainable development.

### **Stephany Griffith-Jones:**

Environmental problems and climate change.

### **Carl Riskin:**

Global warming.

**Jin-Yeu Tsou:**

Water and urbanization.

**Liqing Zhang:**

Development strategy. Whether should China focus more on domestic demand?

**Qing Gao:**

Human security.

**Athar Hussain:**

Building harmonious society; social security net for the poor.

**Roy Prosterman:**

Redistribution and inequality problem.

**Joseph Stiglitz:**

These issues are related to each other.

**Heping Cao:**

We should think first if we want to focus on general issues or specific areas. For instance, how will earthquake or Olympics Game affect economy? For specific areas, such as education, housing, health care, finance, inflation, etc.

**Zhong Zhang:**

Law and development, rule of law.

**Athar Hussain:**

Migration.

**Akbar Noman:**

Macroeconomic issues, exchange rate policy

**Joseph Stiglitz:**

If you come up with further thoughts, please let us know. I really appreciate your coming to this meeting. I thank everyone for your good presentation and active presentation. Thank you.