

Key Points

- Critical among the objectives of the 12th Five-Year Plan is changing the growth pattern toward a more services- and consumption-driven model, away from the past emphasis on industrial production, capital investment, and exports, which is necessary to address the social, environmental, and external imbalances of the People's Republic of China.
- While the key objectives suggest a continuation of the previous plan's policies to rebalance the economy, new features include innovation-driven industrial policy and more determined steps toward a low-carbon economy.
- Rebalancing is unlikely to occur in the absence of bolder policy adjustments. Some key policy areas requiring attention include shifting the emphasis of public spending from investment to public services, further finance sector liberalization, greater private sector participation in the economy, and fiscal reform to reduce income inequality and strengthen local government finances.

Toward Sustainable Growth in the People's Republic of China: The 12th Five-Year Plan

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Revisiting the Rebalancing Agenda under the New Plan

Endorsed on 14 March 2011 by the 11th National People's Congress, the 12th Five-Year Plan (2011–2015) rolls out the main policy directions for further reform and development in the next 5 years. Critical among the plan's objectives is changing the growth pattern toward a more services- and consumption-driven model, away from the past emphasis on industrial production, capital investment, and exports, which is necessary to address the social, environmental, and external imbalances of the People's Republic of China (PRC).

Economic rebalancing was already a key objective in the previous plan, and while some progress was achieved in specific areas (e.g., curbing energy consumption and pollution, and expanding health care coverage in urban and rural areas), progress on the overall rebalancing of targets has been limited. For example, consumption has lagged substantially behind investment, while services have remained at a relatively low level of gross domestic product (GDP). The need to transform the economic growth pattern is stronger now than it was 5 years ago partly because the external imbalances have become more pronounced, and the recent global crisis has highlighted the risks of the export-led growth model.

However, rebalancing is unlikely to occur in the absence of bolder policy adjustments. Some key policy areas requiring attention include shifting the emphasis of public spending from investment to public services, further finance sector liberalization, greater private sector participation in the economy, and fiscal reform to strengthen local government finances. These reforms are reflected to some degree in the new plan, so the challenge lies in how to successfully implement them. This policy brief provides recommendations to that end.

Main Objectives and Targets

While the key objectives suggest continuation of the policies of the previous plan, new features include innovation-driven industrial policy and more determined steps toward the setup of a low-carbon economy. The plan includes 12 binding targets out of a total of 24 main targets. Policy guidelines cover three broad areas of reform—economic restructuring, improved living standards, and environmental protection.

Economic restructuring and innovation-driven growth.

The plan reflects government efforts to make growth more inclusive and sustainable by setting an annual GDP growth target of 7%, and by increasing by 4 percentage points the share of the services sector over GDP during the plan's implementation. These two targets, if met, would facilitate important restructuring and relatively high growth. Industrial policy is expected to lead innovation-driven growth throughout the period, and seven strategic industries¹ have been selected to that effect; their contribution to GDP is set to rise from 3% in 2010, to 8% in 2015, and to 15% by 2020, supported by increased research and development (R&D) spending.

Increased living standards and expanded social protection.

Improving people's livelihood is a priority in the reform agenda. Proposed measures target balancing income distribution and expanding social security coverage. The plan specifies that income per capita will rise by at least an annual average of 7% in real terms under the plan. Employment generation stands as a key objective, and 45 million urban jobs are planned to be created from 2011 to 2015. Reform in income distribution will be approached by increasing the share of labor in the primary distribution of income through wage raises in line with labor productivity gains, and gradual increases of minimum wages. Supportive measures target the expansion of social security coverage. To address existing shortages of affordable housing, the plan envisages the construction of 36 million units of low-income housing by 2015 to cover the needs of 20% of urban households.

Resources and environmental protection. The environmental agenda features prominently in the new plan with 7 of the 12 binding targets set in this area. Energy and carbon intensity are targeted to decline by 17% and 16% per unit of GDP, respectively. Other binding targets include increasing the proportion of non-fossil fuels in primary energy consumption (by 3.1%), curbing the release of major pollutants (by 8%–10%), eliminating the loss of arable land (i.e., at 0%), reducing water consumption per

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unit of industrial value added (by 30%), and increasing forest coverage (by 1.3%).

Implementing the Plan—Policy Directions

Given the depth of the envisaged reforms, the 12th Five-Year Plan stands as one of the most important plans since the foundation of the PRC. Following the plan's endorsement, policy making should turn to developing detailed blueprints to guide the implementation of the main policy guidelines. Against this background, the following policy recommendations are suggested.

To Support Economic Restructuring

Increasing the services sector's share of GDP. A larger services sector will support economic restructuring and the achievement of some social and environmental targets set in the plan. Services entail large employment generation potential, and are 60% less emissions-intensive than the economy as a whole, and 90% less than manufacturing. Developing the services sector would thus absorb the rural–urban migration stemming from urbanization, and reduce the carbon footprint of the expanding cities. The proposed 4 percentage point increase in the share of services in GDP is thus desirable but ambitious, taking into account the 11th Five-Year Plan's failure to meet its 3 percentage point target by half a percentage point.

Liberalizing services. Developing services requires the timely implementation of supporting policies, including upgrading of human capital, removing barriers to entry, reviewing the incentive bias in manufacturing to grant equal footing to services, and opening up to foreign direct investment in the sector. The restricted exposure of services to foreign direct investment has hampered its implicit technological transfer, thus limiting the expansion of the sector and the quality of the services.

Fostering distributive services industries. Due to its labor-intensive nature, a larger services sector would support government efforts to create 45 million new jobs

¹ Non-fossil energy, environment technology, new materials, high-end manufacturing, biotech pharmaceuticals, information technology (including internet-based services), and new fuel-powered vehicles.

under the plan's duration over the next 5 years. This could be achieved by focusing on distributive services industries, wholesale and retail trade in particular, which would require relatively short-term training programs to be staffed. The scope for employment generation in this area is significant, as it employs only 4% of the urban workforce compared to 15% in the United States (US). Other subsectors with similar potential are domestic transportation and supply-chain industries.

Upgrading human capital to support innovation-driven growth. Success in fostering innovation in the seven strategic industries and achieving comparative advantage in world markets will highly depend on investments in R&D, which are targeted to increase from 1.8% of GDP in 2010 to 2.2% under the new plan. However, the previous plan failed to meet its 2% target, illustrating the difficulties of increasing R&D expenditure without simultaneously upgrading education, developing new skills, and promoting science and engineering in tertiary education. In recent years, the share of science and engineering degrees in tertiary education has declined in the PRC, hampering innovation.

Promoting private sector participation. Economic rebalancing and innovation-driven growth would benefit from greater private sector participation. While some state-owned enterprises are highly profitable, private companies generate the largest share of GDP growth and employment in the economy today. In this context, determined efforts to promote small and medium-sized enterprises are essential, as they generate 65% of patented inventions and produce about 80% of innovative products in the PRC.

Developing capital markets. Liberalizing the finance sector, including capital markets, will improve the allocation of capital in support of the transition to an innovation-based economy while lowering the cost of, and improving access to, finance. More sophisticated capital markets will foster innovation through wider access to international and domestic capital markets and new financial options (e.g., venture capital or private equity for new technology companies to expand domestically

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and globally). This reform is crucial to support the development of the seven strategic industries, the cost of which has been estimated at over \$800 billion.

To Increase Living Standards

Aligning wages with GDP growth. Announced increases in minimum wages will not significantly affect income and consumption in the absence of reforms to the regulatory framework. Existing regulations allow for excessive flexibility for local governments to set minimum salaries, which remain low at 25% of the average local salary (Organisation for Economic Co-operation and Development median is 40%). Further, the impact of the minimum salary policy on consumption will be limited due to the small share of the labor force receiving the minimum salary (less than 5% in the main cities). For instance, the tripling of minimum salaries in Beijing and Shenzhen in the last decade has resulted in a significant fall in private consumption as a share of GDP. Plans to align wage increases with productivity and GDP growth would have a larger impact and prevent the share of labor in GDP from declining further.

Prioritizing social spending. Personal income at 42% of GDP is low by international standards (85% in the US; 78% in Taipei, China). Higher wages will not foster consumer spending if precautionary savings remain high. Savings rates in the PRC have increased dramatically since state redistributive mechanisms weakened in the transition toward a market-oriented economy. Only about 38% of government revenue is spent on social security, education, and health care, against an average of 52% in countries with similar income levels. In this regard, the new plan lacks ambition and continues to focus reforms on coverage rather than on benefits. More effort is needed to reduce households' uncertainty about the cost of health care and lack of security in regard to retirement income to reduce precautionary savings and favor consumption. A large up-front financial injection to

the underfunded social security fund (total assets at \$470 of lifetime retirement benefits for the average worker) would instill greater confidence among households, without straining public finances given PRC's strong fiscal position.

Overhauling taxation to balance income distribution.

The new plan acknowledges the important role of fiscal policy to narrow income inequalities, but the proposed reforms are insufficient to address major constraints. Given the limited number of personal income taxpayers (only 26 million taxpayers), the government's proposal to increase the minimum income tax threshold (from CNY2,000 to CNY3,000 per month) will not significantly impact personal incomes and consumption expenditures. Because direct taxation is more effective in adjusting income differences, it would be more equitable to make the tax system more progressive and move away from the current emphasis on indirect taxation, which is more effective in raising revenue but highly regressive. Taxing capital gains and property, and introducing inheritance and gift taxes would also help balance income distribution while offsetting revenue losses from the transition to a more progressive tax system.

Aligning expenditure and revenue shares at the local level.

An action plan is needed to overhaul the tax revenue sharing system between central and local governments. This will align expenditure responsibilities with revenue allocations at the local level thereby improving the provision of public services. This is particularly urgent in light of the announced low-income housing program, the cost of which will primarily be shouldered by local governments, some of which are highly indebted because of their central role in financing infrastructure projects

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through local funding vehicles under the massive fiscal stimulus program implemented in 2009–2010.

To Strengthen Environmental Protection

Introducing green taxation. While the plan contains ambitious targets for environmental protection, there is still scope for further improvement by introducing green taxation. A tax on coal at modest carbon prices (\$20 per ton of CO₂) would provide an incentive to use it more efficiently, and yield revenues equivalent to 2%–3% of GDP that could be invested in developing low-carbon technologies. Removing administrative controls on the price of water and electricity would rationalize their use and consumption—and introducing natural resources taxation nationwide will have similar effects—while increasing revenue at both the central and local levels.

Fine-tuning environmental targets. Targets to reduce energy and carbon intensity are set at 17% and 16% per unit of GDP, respectively. However, the targets could be increased to 20% based on progress achieved under the previous plan and strong government commitment to combat climate change. In light of announced plans to accelerate urbanization, more efforts are needed to facilitate a sustainable process for this under the framework of a low-carbon economy, including improved water and land management.

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