

## CHINA NEEDS A SCIENTIFIC VIEW OF GOVERNMENT, TOO

Eliot Cutler, *Caijing magazine*, November 12, 2007

The conventional wisdom abroad is that President Hu presides over an all-powerful centralized state. Wrong.

A “scientific view of development?” Most people outside China believe that President Hu Jintao should be able to make that happen with a snap of his fingers. Nothing, of course, could be further from the truth. Rebalancing economic growth in China, so that it careens less toward development at any cost and pays greater attention to the population’s social welfare needs and to environmental protection, will be a tall order – and success in turning this corner will enshrine President Hu in the pantheon of China’s greatest leaders.

It will take more than calls to patriotic responsibility to make this happen, however. President Hu needs to execute a policy U-turn that will strengthen a national government that has shrunk in proportion to a burgeoning economy and is consequently hard-pressed to improve environmental quality and ensure the production of consistently safe and high quality goods. Although these clearly are the President’s goals, the Beijing government’s limited reach into the provinces threatens to stall his ambitious agenda.

The product calamities of the past several months and the continuing environmental damage threaten China’s economic development and its international image. But neither can be tackled properly unless Beijing finds a way to overcome resistance in the provinces and assert more order over its free-wheeling economy. During 30 years of impressive growth since the post-Mao reforms, China’s economy has become a vigorous and competitive market economy – but also a much less directed one. It is now in desperate need of more order and regulation.

The furor over faulty exports that has roiled China’s relations with its principal trading partners should accelerate two of the most significant changes that we will see in China’s next decade – more government and fewer companies. These are changes that President Hu’s policies probably will set in motion, because he realizes that the relationship between growth and sustainability has spun badly out of whack.

A stronger central government? In China? Well, yes. Recent reports suggest that there are 9,000 *chemical* plants discharging effluent into the Yangtze River alone. There may be more than 10,000 manufacturers *of toys alone* in China. This is a country where Chongqing, nominally a city, is nearly as populous as the entire State of California, the world’s fifth largest economy.

The industrialization of America that took generations has happened in China in just a few years. Factories in highly fragmented and cut throat manufacturing sectors pare margins to the bone in order to beat out their neighbors for orders and market share. Bad ingredients are sometimes substituted for good ones, if they are cheaper and non-apparent. And costs for external benefits like clean air and water simply are not incurred if they cannot be recovered in product pricing. Where the environmental damage wreaked by America’s growth happened slowly, with no one watching, today’s global climate circumstances unfortunately don’t give China as much time as America took to get it right.

China is not America, and the environmental challenges the Chinese face are more challenging – as well as more urgent – than any we have confronted in the U.S. Nonetheless, some measures that were

taken at the federal level in America three and four decades ago in order to correct imbalances similar to those that now confound China might be examined by a Chinese leadership looking for ways to solve their own problems.

The U.S. Environmental Protection Agency (EPA), created in 1970, ultimately was given cabinet status and the authority to regulate all nonmilitary programs and activities of other federal, state and local government agencies. China's national environmental agency might well benefit from a similar upgrade. Today, the head office of China's national environmental protection agency is staffed by only a few *hundred* people, and one can imagine how difficult it will be for that agency to set uniform nationwide standards, monitor performance across hundreds of manufacturing sectors and gain reliable compliance in 31 provinces without a new status, more authority and more people.

Under the U.S. federal National Environmental Policy Act (NEPA), every major federal government action, program or activity must be preceded by a statement of the adverse environmental impacts that might flow from the project and must discuss alternatives to it. Most important – and of potential significance for China – the ultimate arbiter of the adequacy of the impact statement is someone *other than* the project proponent.

And the U.S. federal Clean Air Act established air quality control regions based not on political boundaries but on air sheds. The law required that states and local governments cooperate on plans to control emissions within these regions. The key to making them pay attention, and the point of greatest relevance to China today, is that the plans had to promise results by a particular deadline, had to be approved by the EPA and had to be followed by the states and localities. If they weren't, the states would lose precious federal highway grants and the authority to make their own cleanup plans.

So, what should happen in China? It is not so much a matter of needing *bigger* government as it is needing a government with more authority and the capacity to enforce uniform regulation throughout the country in a way that is predictable and yields consistent results. Over time, we should expect that the national government will become more of a regulator and less of a promoter, that a stronger group of regulators with more employees and fewer overlapping jurisdictions will impose rules and standards that will be clearer and more evenly enforced. The government's regulatory reach into the provinces likely will become much greater, and it will learn to use economic incentives and other financial mechanisms more effectively to gain cooperation from provincial and local officials.

At the same time that the national government gets bigger, the manufacturing sector in China should begin to consolidate dramatically.

There are a legion of forces lining up to spur consolidation. Chinese entrepreneurs are attracted by the substantial profit margins that brands and distributors reap compared with the paltry margins generated by thousands of sourcing factories competing with each other. Driven to climb higher on the value chain, these entrepreneurs will steer billions of RMB from China's growing investment sector into rollups, will capitalize these consolidated companies and will begin buying the hands that have fed them. Not incidentally, fewer and better capitalized companies will be better able to comply with tougher environmental, health and safety regulations, to increase efficiency and productivity in order to compete with lower-wage competition from Southeast Asia and eventually Africa, and to compete globally for the best and the brightest design and managerial talent.

All this will happen, but it won't happen overnight. In the meantime, companies in consolidating industries that can impose effective self-regulation can help Beijing work through this transition to a stronger national framework. Beijing should welcome any such initiatives, because the policy U-turn won't be easy.

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Editorial response:  
**A Powerful Central Government Does Not Mean Residue of Planned Economy**

Lu Lei, *Caijing magazine*, November 12, 2007

There is no doubt that it's an inherent function of governments at all levels to re-distribute social welfare. However, only the central government shall and must be the ultimate re-distributor of interests in a society.

Market is an initial distributor of economic interests, but in many occasions market may fail to function properly, for example on such issues of environment pollution and intellectual property rights protection. The key point here is to have in place an accountability regime where those who enjoy the benefit should also pay the costs.

Many disastrous events have once and again justified this insightful observation: the pollution in Huaihe River and Taihu Lake area; and the distribution of water resources between the upstream and downstream areas of the Huanghe River. The former case shows that certain profit-driven enterprises have hijacked the people living in the area to pay the costs of severe pollution, while the latter one indicates the tension between the upstream and downstream areas as a result of excessive exploitation of a lifeline river and conflicting local interests. All these problems require arbitration, coordination and policy solution at the central level.

A seemingly justified argument goes that a powerful central government is a residue of planned economy, while local governments are regarded more as the spokespersons of market economy. However, the basic principle of market economy requires an explicit boulder line between government and market, and that any government shall not mix itself with the market, let alone to act as the spokesperson of the market. The sole legitimate function of government is to solve the problem of a market failure.

Of course, this only justifies the existence of government, not the necessity for a powerful central government. However, through hindsight of various historical events, we must admit that local governments do have certain characteristics for the spokesperson of market economy, and therefore, only the central government can take on the responsibility to adjust a distorted market, due to the simple fact that any such failure will be eventually at the cost of the central government.

Government should be independent of the market, and the central government should have the capacities and resources needed for coordinating between different interests. As the above article [written by Eliot] has pointed out, at least the local governments are not independent of the local interests, which is nothing wrong in itself. The problem is, many local governments are now pursuing their local interests at the cost of other individuals and entities. To solve such problem, we will need two things, first is the Constitution; and second is the enforcement body of the Constitution—the central government. The Constitution provides the rules for resolving conflict of interests, and the central government shall enforce such rules. Under the constitutional framework, the central government shall only represent the interests of the whole people, and the Constitution itself should be one with the “unanimous agreement” advocated by James M. Buchanan.

To conclude, we have reason to call for a powerful central government, as ancient scholar Jia Yi put it, “for the lasting peace of the kingdom, the best way is to increase the number of dukes and princes, thus make them less powerful.”