Beyond GDP growth in China

By Zhang Jun

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At last year's 19th National Congress of the Communist Party of China, leaders reminded local officials that, when it comes to economic growth, they should be focused on quality, not quantity. But if local governments are to succeed, China's leaders will need to update and clarify the incentive system that fueled past success.

China owes its economic-growth miracle largely to local governments. But, as the country attempts to build a more modern and sustainable economy, in a context of lower overall growth, local governments need to adapt. What will happen when they do?

Despite the occasional inappropriate intervention, local governments have been very successful in preserving the market and fostering the spirit of entrepreneurship over the last three decades or so. They have promoted local infrastructure investment, reined in bureaucracy, created an attractive business environment, and enacted preferential short-term supportive policies. But it was always GDP growth that was their main – and, in a sense, only – objective.

This focus on GDP growth is a direct result of the incentives created by the Communist Party of China (CPC), which has long promoted local officials based exclusively on the GDP gains they oversaw. According to recent research by Li Xing and his colleagues, this political competition caused the central government's growth objectives to be significantly amplified at the local level: the lower the level of government, the more ambitious the objectives have been.

In fact, to boost their chances of promotion, local officials would aim to exceed even the highest established targets, viewing them as a lower limit. For example, Li's research showed that in 2006-2010, the average provincial growth target was 10.15% – which was 2.6 percentage points higher than that of the central government. Yet the actual provincial growth rate for that period was, on average, 13.07% – nearly six percentage points higher than the central government's target. Those targets ensured that, whatever GDP growth they realized local governments were always striving for more growth.

But things have begun to change in recent years, with the gap between growth targets at the national and local levels narrowing progressively. According to my estimates, since 2013, the actual growth rates of the eastern coastal provinces have been only slightly higher than their target rates – a far cry from the 3-4% surplus growth recorded in the previous ten years. For some of China's inland provinces, such as Inner Mongolia, even meeting established targets has proved difficult, to the point that failure to do so is considered acceptable.

This partly reflects weakening prospects for GDP growth, though the actual decline may not be as large as it seems. Last year, officials from Liaoning, Tianjin, and Inner Mongolia publicly acknowledged that they had previously overestimated their growth contributions. The subsequent announcement that, as of next year, the National Bureau of Statistics in Beijing would take the lead in local GDP accounting – together with the growing acceptance of lower growth rates – impelled provincial governments to reassess their reported statistics.

The results were stark: reported nominal GDP growth rate for China's 31 provinces dropped from 13.8% in the third quarter of 2017 to 4.3% in the fourth quarter, even though

China's overall GDP has remained consistent. For nine provinces – including Shanghai, Zhejiang, and Shandong – the rate of nominal GDP growth turned negative.

While this slowdown may be a cause for concern, particularly in the places where it has turned negative, it is not all bad. After all, economists have long criticized China's local governments for their excessive focus on GDP growth, which fails to account for important components of human welfare like physical health and a clean environment.

To address this failing – while coping with economic conditions that simply cannot deliver double-digit growth indefinitely – China's central leadership has, in the last five years, begun to change the way it evaluates local officials' performance. Now, beyond GDP growth, local governments must work to transform and upgrade the local economy, foster technological innovation, protect the environment, reduce poverty, and mitigate financial risks.

The goal, of course, is to harness local governments' demonstrated ability to bring about change to address some of China's pressing challenges. But the fact remains that GDP growth is a lot easier to measure than many of these new indicators, meaning that China's much-lauded incentive system is about to become more complicated and less certain.

At last year's 19th National Congress of the CPC, Chinese leaders reminded local officials that, when it comes to growth, they should be focused on quality, not quantity. This is a positive – and necessary – step. But, if local governments are to achieve the same level of success as they did when their focus was GDP growth, China's leaders will need to find an alternative to the current incentive system and a way to discipline its local officials, who have served the country's economic development so well in the past. And that will be a serious challenge.

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