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### Public Finances and Social Harmony in China

Before addressing some specific issues which the OECD economists have raised with respect to the challenges for China's public spending, I would like to put the issues in a somewhat broader context that is applicable to all economies, developed, emerging and developing.

In previously addressing this Forum, I described the principal role of government as finding the appropriate balance in a triangular paradigm underlying economic and social progress.

The triangle is anchored in one corner by economic growth, in another by social harmony (sometimes referred to as social cohesion), and in the third by good governance. Good governance ensures the appropriate framework conditions to maximize economic growth through the interplay of market forces...goods, services, labor and financial markets.

But growth alone is not enough to find the balance. There must be an effective transfer of the benefits of growth to society as a whole to maintain balance and to move societies forward effectively and equitably. That is where the amount and quality of public spending becomes critical, a subject I will address in a moment.

Too often the success of societies is measured in terms of economic growth or gross domestic product per capita (GDP). While that number is important, it tells us very little about the balance in the paradigm I have described.

The analogy I used before was that of a tightrope walker holding a balancing rod. When in balance he or she moves forward. When not in balance the walker fights to stay upright and in the worst circumstances falls off.

Our societies are analogous to that tight rope walker, the walker being the government. Too much economic growth weighing down one end of the balancing rod with insufficient social harmony or cohesion at the other end will slow down or arrest societal progress. By the same token, compromising economic growth through suffocating market forces in order to satisfy unrealistic social demands through excessive public expenditure supported by high taxes or public debt, has the same effect. We see examples of both these phenomena within the OECD membership and beyond. In some cases there is good growth yet a growing disparity between the haves and the have nots. In others, economic growth is far below potential, and unemployment is too high.

So I return to my thesis that the challenge of government is to find the right balance and maintain this so as to ensure continual progress, raising standards of living and quality of life while avoiding revolutions and strife, or in the case of democracies, defeat at the next general election.

Because of widespread dissatisfaction with GDP as a proxy for social progress we are currently doing significant work at the OECD in attempting to measure the progress of societies along that tight rope. How are societies really doing in sustainable development as broadly defined: the economy, social harmony and the environment? Indeed there is an international conference in Italy in a few days on this subject.

I would now like to turn to public expenditure policies in general and China's public spending in particular.

There appear to be three sets of issues concerning public expenditure policies.

First, one needs to consider whether the level of public expenditure is appropriate to a country's economic circumstances. Is it sustainable and controllable or does it risk macro economic stability? In this regard, one should note that a number of important considerations apply. For example in many countries including my own, public indebtedness soared as a percentage of GDP in order to create fundamental infrastructure, including railroads, canals, harbors and roads which would bring enormous benefits later in overall economic development and increased productivity.

The second set of issues, which are especially applicable to social harmony, involves the question of whether public funds are being optimally applied with respect to social and economic goals. Are there alternatives such as an effective regulatory framework for a particular area or sector which could attract private sector capital? Could a private /public partnership be effective, even for the creation of basic infrastructure? I would note that there seems to be much more scope for such creative financing than there was a century ago, probably because financial instruments and arrangements have become more sophisticated.

Think of the remarkable Millau Bridge over the Tarn River in France where private sector financing of the structure is supported by the right to operate and apply tolls for a defined number of years before it reverts to public ownership. This is just one example, but there are many possible approaches to be considered.

The third set of issues concerns the technical efficiency of public expenditure, where the OECD has done significant work. These are public sector management issues such as the budgeting process, monitoring and evaluation.

These together represent a way of assessing the quality of public expenditure, a subject of great importance to all governments and to all economies.

Let us review some significant OECD findings with respect to China's public expenditures.

Our studies suggest that China's policies reflect an incomplete transformation from a centrally planned economy to a more limited and focused approach, which is characteristic of market economies. Completing this transformation is a challenge. For example:

The perceived scope of public expenditure does not appear excessive but the government controls or heavily influences much off-budget spending, which is non-transparent. In market economies, of course, such spending would be made by the private sector or through an explicit government budget line. This is not of itself an issue of social harmony except to the extent that the public should be able to ascertain the true situation.

The second challenge arises from the extraordinary rapid growth experienced by China, so that expenditures are now substantially higher as a percentage of GDP than in the mid nineties. OECD analysis suggests that public expenditures could slow but there remain some important contingent liabilities, notably non performing loans held by the banks.

There are other issues of public expenditure which bear upon the question of social harmony, especially the horizontal allocation of public funds.

The horizontal allocation of funds does not currently seem to match China's development needs and priorities. International benchmarks suggest that more needs to be spent on key social services such as education, health and science and technology.

Without embarking on the detailed study conducted by the OECD, it is clear that there must be an orientation away from physical capital, where in any case there may be opportunities for private sector engagement, and towards improving human capital with a consequent rise in education levels, skills levels, incomes and quality of life. And this is especially important in China to begin closing the poverty – wealth gap.

We know that in China this gap is primarily due to the disparity between the wealthy coastal and urban areas and the rural areas where two thirds of the population remains.

In this regard, I note that on March 5<sup>th</sup>, Prime Minister Wen unveiled an ambitious “historic task” to “narrow the...gap between rich and poor and enliven the country's vast but still impoverished rural areas.”

This is a perfect example of searching for social harmony through public expenditure. The main points of the proposal are:

- *Public services*: Improve rural education and health services. This includes speeding delivery of universal 9-year education in 2006–07 and developing a rural health system nationwide by 2008.
- *Pro-agriculture policies*: Strengthen farmer's land contracting rights. Improve the rural financial system. Promote technological development in agriculture and increase direct subsidies.
- *Promote urbanisation*: Speed up migration to urban areas, especially small towns. Eliminate regulations and policies that discriminate against migrant labour in urban areas.
- *Develop a rural safety net*: Gradually develop a social security system for migrant labour, and better enforce regulations that protect workers from exploitation. Target poverty-alleviation.
- *Rural investment*: Increase infrastructure investments, especially in paved rural roads. Fully abolish rural taxation, improve fiscal transfer mechanisms.

These first five points are in line with the recommendations of recent OECD studies, except that raising direct subsidies to farmers runs against the praise of our recent Agricultural Review for the low level of farm subsidies in China.

Finally, the strategy recommends

- *Strengthening rural “democracy”*: Improve village self-governance (through the Party), further increase transparency. Promote rural legal systems.

Returning to my triangular paradigm, these proposals represent a use of public funds to promote economic growth in rural areas and to promote social harmony. Many of the proposals also represent an investment in human capital which is becoming the driving force in knowledge based economies, the direction in which China too is headed.

Indeed, investment in improving the quality of human capital, especially through education should be seen as an investment on national balance sheets, in my view, the most important, and ultimately the greatest contributor to social harmony.

Thank you for your attention.