

**Transition of China's Northeast: The Need for Combining Regional and National Policies**

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In less than a quarter century China has become an international symbol of economic success and has delivered proof that empowering individual initiative in an appropriate institutional and economic environment can achieve fast and enduring economic and social progress.

China's experience has indeed become a source of inspiration to much of the developing world, keen to emulate China's remarkable performance. With an astounding 8 per cent growth per annum over the past 2 decades, representing a doubling of production every 10 years, China ranks among top growth performers of the world economic history. Its reserves, now about \$400 billion, are the second largest in the world after Japan, and are insulating it from major fluctuations in global economic activity, while at the same time they help to guarantee the feasibility of further reforms. Such reserves were accumulated thanks to a bold strategy of opening up to the world economy. China's share of world exports has increased from 1 percent to almost 6 percent between 1980 and 2003, nearly the same share as that of Japan today. During the same period, the export or import/GDP ratio has increased from 5 per cent, nearly a closed economy, to 25 per cent, a proportion which had never been observed for a large economy. Most importantly, this economic progress has translated into large scale poverty reduction, altogether one of China's greatest accomplishments. World Bank estimates suggest that the transformation of China since 1979 has lifted 400 million out of (\$1/day) poverty. At the global level, this has undoubtedly been the single most important contribution to the reduction in world poverty in the last quarter century.

Such amazing successes do not guarantee that the future will be devoid of major difficulties. China's transition is not over yet and some of the challenges that lie ahead are quite formidable. The Northeastern provinces, which are the subject of today's discussion, provide a clear illustration of them.

Although originally the Northeast was one of China's major industrial centers, its competitive position has been challenged by natural resource depletion, shifting demand, and changing market structure. China's international trade has grown in importance and drastically changed regional comparative advantages. Other regions have shown a more dynamic adjustment to these changing opportunities, due perhaps to their initial specialization and lower susceptibility to investment inertia, as well as to local government policies. In any case, the Northeast provinces now appear to be what has been called elsewhere a 'rust belt region', with aging and less competitive industries. There is clearly a need for a major transition in order to recapture the strong economic performance that once characterized the region's industrial past.

### **'Rust-belt' transition: regional vs. national challenges**

Experiences with this kind of 'rust belt' transition are not uncommon in industrialized economies. Gains from international trade and economic transition are typically possible only at the often painful cost of adjustment in less competitive sectors. Difficult regional economic restructuring has been imposed on many countries, beginning with the most industrialized ones. The re-conversion of steel and coal mine regions in Belgium, France,

Germany, Ireland or the United Kingdom through the 1970s and 1980s provide good examples of this process. National policies were often aimed initially at protecting rust-belt regions and industries through trade barriers— as is the case today with special steel tariffs being levied by the US. When these proved difficult due to international trade agreements, governments often resorted to targeted subsidies. However, these policies have most often proved to be highly costly and have generally failed to improve industrial competitiveness. Policies to facilitate German unification may be cited as an example. Massive transfers and subsidies were used to attract new capital and facilitate labor shedding in eastern Germany, but the region's industries are still not very competitive and the region remains highly dependent on central government transfers, the cost of which would not be affordable for most countries.

More successful have been programs targeted to facilitating the transition to other activities, for instance through policies aimed at guaranteeing an attractive investment climate, through generous social assistance to laid-off workers, including measures to facilitate migration, and through ambitious job placement and re-training programs. There have been examples of success, although the transition has often been long, costly and socially difficult. The experience of converting industries in the United Kingdom and Northeastern France are both such examples.

Some lessons may be drawn from this international experience for North-East China, and I will be dealing with some of them in the rest of this speech. However before looking at some specific issues I would like to emphasize three problems which make the transition in Northeast China very different from, and more difficult than, the foreign experience just mentioned. They have to do with some of China's *national* development challenges and the way they tie with regional issues.

The *first* problem is the limited factor mobility in China, by which I mean mobility of labor and capital. Most of the re-conversion experiences I alluded to above have relied on labor movements out of the region in transition. Indeed, an effective way of offsetting the negative effect of declining industry on labor incomes is to have some people leaving the region in order to improve their standard of living. By doing so, they contribute both to increasing the income per capita in the region and also to making the skills of the remaining labor force better adapted to substitutive industries. At the same time financial markets can support capital inflows into newly emerging industries, sometimes with the help of public subsidies. This helps create new employment opportunities in emerging industries which often require a different skills mix. Limited labor mobility in China may serve to prevent this mechanism from operating effectively.

The *second* impediment for a fast and efficient transition in the Northeast is the general lack of domestic integration of the Chinese economy, which prevents potential industrial linkages from being fully developed. Vigorous growth in some regions should normally have an impact on other regions through additional demand for intermediate products or services, or through making new products and services available at a lower cost to other regions. Economic restructuring is thus made easier through taking advantage of new manufacturing and service sector opportunities which emerge in the more dynamic

regions. Such an evolution will doubtlessly occur in the future. Today, however, several conditions for a satisfactory integration of the domestic economy still have to be met, in particular satisfactory infrastructure for transport, information flows, and credit.

The *third* difficulty is the lack of fiscal instruments for inter-governmental redistribution. Expenditure assignments at sub-national levels are excessive by international standards, and often inefficient, and they greatly exceed revenue assignments in the poorer or distressed regions. Improving the investment climate in the Northeast through investing in infrastructure, retraining employees, improving logistics, etc., requires additional financial resources which cannot be levied on a slow growing local economy with rising unemployment. Introducing the instruments to transparently redistribute resources from high growth regions to restructuring regions is thus a necessary tool for facilitating the adjustment of the latter. It should go without saying that such redistribution needs to be temporary and to promote restructuring—not postpone it.

These points suggest that the success and speed of the transition in the Northeast depends very much on urgently addressing reform challenges that are intrinsically national. However, having said this, there are still many issues that must be addressed at the regional level. Let me focus on three of them.

### **Efficient integration in the domestic and the world economy**

China's accession to the WTO and economic liberalization agenda will change the structure of activities in China, and indeed this process is already well under way, offering many new opportunities. Likewise, future progress towards a more integrated domestic economy will provide many new opportunities for regional specialization. It is within such a perspective that the North-East must reflect on the competitive 'niche' it will occupy, developing those areas where it enjoys a competitive advantage nationally and internationally. Given its industrial past, its advantage may continue to rely on heavy industry, such as the automotive sector. Or maybe the region's competitive advantage lie elsewhere, in petrochemicals, pharmaceuticals or machinery? Which sectors are most likely to develop first is the question that must be answered.

The answers to this question may be necessary to help determine the kind of complementary public policies needed to attract investment in new activities. What are their specific infrastructure requirements? What kind of training programs? Reflection in this direction should also benefit from coordination with the central government in order to make sure there are not too many regions competing to attract the same activities, and avoid competitive use of subsidies that are costly and can lead to a 'race to the bottom' across competing regions.

Attention to the restructuring of manufacturing and services should not detract from the rural economy. Accession to WTO is affecting farmers negatively, particularly in the Northeast where I am told the removal of export subsidies for maize and lower tariff protection for oilseed crops is adversely affecting rural incomes. Hence, the greatest cost to the region of slow growth in the industrial sector may lie in the difficulty in absorbing

labor which must migrate from rural areas as agricultural restructuring proceeds. This is of course a national problem. But for the Northeast it underscores the urgency of successful industrial restructuring.

### **Investment climate policies**

In most re-structuring experiences the answer to the preceding question about identifying regional comparative advantage came *not* through government decision, but through market mechanisms and spontaneous location decisions of new and existing enterprises and entrepreneurs. Re-structuring policy thus involves attracting potential external investors and entrepreneurs, as well as to retain investment from existing sources within the region, there needs to be a supportive ‘investment climate’. This refers to the attractiveness of a specific location – a city or region – for investment across several dimensions, including availability of labor, credit, infrastructure, ancillary business services, regulatory environment, efficient legal adjudication of disputes, and stable prices and markets.

The World Bank has been engaged in assessing the comparative quality of the investment climate, both internationally and across major municipalities in China, through using investment climate surveys of local firms. These surveys examine roughly twenty different elements of the local investment climate, which assess the quality of infrastructure, the cost to firms of local administrative controls or ‘facilitation fees’ arising from corruption, the availability and cost of skilled and unskilled labor, access to credit, etc. Four cities from the Northeast were included in the surveys covering nearly 4000 firms in 23 major cities in China. These are Dalian, Changchun, Harbin, and Benxi. The survey evidence was used to rank cities by the quality of investment climate and points to a wide variation in performance across the Northeast region. It clearly shows that Changchun and Dalian have a moderately strong investment climate, ranking in the top half but near the middle of the distribution. However, both Benxi and Harbin are found to have a far less satisfactory investment climate, ranking in the lowest category of cities [Figure 1].

There is no time now to go into the details of these surveys, but what I wish to emphasize is that there is considerable scope for improving the investment climate to make the Northeast more competitive with other cities in China and internationally. While in some areas the Northeast is found to be comparatively strong, such as in the quality of power and transport infrastructure [Figure 2], in other areas, such as effective tax levels or investment in staff training or access to loans by firms, the Northeast is found to be weaker [Figures 3 and 4]. For example, in Benxi and Harbin the average skill of the labor force appears to be lower than in other cities with comparable technological levels, and tax rates on total sales also appear to be substantially higher than average.

Of course, measures to improve the investment climate are costly. Investing in improving transport infrastructure or communications requires additional resources, financial incentives to new industries reduce tax receipts (although international evidence suggests they are often not necessary if other factors are favorable), and public training

programs may need to be financed. Additional support for this may be necessary from outside the region, particularly if local tax revenues are under strain from declining growth performance or rising costs of social support programs and other competing public investment needs.

### **Safety nets**

Even with the adequate policies in place, transition is a long and socially painful process. This has been the case in more or less all experiences of regional restructuring, even the most successful ones. Hence it is important to have safety nets that protect workers who must move between jobs or between sectors from suffering an unbearable fall in their standard of living. I am told that experimentation with innovative safety nets is already underway in the Northeast, in particular in Liaoning province. These pilots may help to set national standards for safety net reform in China. This certainly is a positive contribution to the transition process since job restructuring may be pursued at a lower social cost and therefore more efficiently. But two observations are in order.

The first is that existing safety nets concern mostly the urban sector, although there is strong evidence that the rural sector has been, and will be directly and indirectly affected by the transition. Evidence from provincial level household survey data shows that rural poverty is a serious issue in the Northeast, particularly in Jilin and Heilongjiang provinces where rural poverty now exceeds the national average [Figure 5]. What kind of safeguards should be offered to that part of the population dependent on the rural economy? It is worrying to see that rural poverty has decreased much less rapidly over the 1990s in the NE region than in the rest of China. Moreover, there is some evidence that rural poverty among the most vulnerable (i.e. those far below the poverty line) has actually increased in some areas, particularly in Jilin province. Without adequate safety nets in rural areas, this tendency may persist in the future, or reducing poverty might even stop – something not very far from what appears to be happening in Jilin according to World Bank data.

The second precaution to be taken is to ensure that safety nets do not actually prevent migration from taking place. The risk is that too generous a safety net, for instance through the minimum income program (*dibao*), may reduce the incentives that Northeast inhabitants may have to migrate to more dynamic regions, or even to cities within the region. As seen above, migration is necessary for an efficient reallocation of labor throughout the country. Provided that precautions are taken to prevent the region from being depleted of necessary labor skills, migration will contribute to increasing the income of *both* those who migrate and those who do not. All this suggests that maintaining and possibly developing efficient safety nets in the Northeast region must go hand in hand with policies that facilitate migration.

Another way of preventing a fall in the standard of living is to facilitate greater investment in human capital. Of course, such a policy is likely to produce effects only with some delay. But, at the same time, it may also contribute to increasing regional competitiveness, improving the investment climate, and perhaps most importantly,

contribute to the ability of rural migrants to compete in finding employment in expanding industries in urban and peri-urban areas.

## **Conclusion**

I would like to conclude these reflections on the transition process in Northeast China with some remarks on the importance of safety nets and national solidarity. Both are important in the overall process of economic restructuring, a process made necessary by changes in international comparative advantage as well as sometimes inherent to the general development process of an economy. My comments are based on the comparative experience of continental Europe and the United States since the mid 1970s, which I believe may hold lessons for China.

Europe and North-America have been through extensive economic restructuring since the mid 1970s, due both to rapid technical change and to the rapid expansion of international trade, including competition from developing countries, especially in East Asia. However there have been important differences across countries, in particular in terms of changing household inequality over this period. In continental Europe and Canada, restructuring took place without major changes in the level of inequality, whether within or between regions. In the US, inequality across households increased significantly, but no major increase in inequality between regions took place.

Behind these divergent experiences lie differences in social safety nets and market mechanisms. The highly effective safety net systems in Europe and Canada, prevented households from being hurt during restructuring, although at a cost of higher unemployment. Because their safety nets are centrally managed, this in effect implied some strong redistribution from regions which were doing well to those with higher unemployment and slower growth. Lower taxes could be levied on the latter and more benefits were redistributed towards them. In the US, by way of contrast, less effective and less generous safety nets led to greater social costs from restructuring, which fell most heavily on unskilled labor. But at the same time greater flexibility in US factor markets contributed to spreading this cost evenly across regions and also ensuring that resources were more fully utilized (unemployment did not reach European levels, and fell relatively quickly). In the first case, national solidarity re-equilibrated income per capita across regions through centrally managed safety nets and implied inter-regional redistribution.<sup>1</sup> In the second case, a similar inter-regional result was achieved thanks to the tight integration of the economy and the flexibility of factor markets, although with rising inter-household inequality.

The experience of China over the last 25 years has been quite different. In China total inequality has increased quite substantially, a major part of that increase being due to inter-regional disparities, as well as an increasing rural-urban divide [Figure 6]. The latter is not a new phenomenon, whereas the former is new. Inter-regional inequality

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<sup>1</sup> Note that this argument refers more to European nations than to the European Union where explicit inter-regional redistribution schemes are in place.

over the past half century has never been as high as it is today.<sup>2</sup> What is more worrisome is that it is continuing to increase rather rapidly. A comparison with the experience of European countries and the US suggests it is either the lack of a well integrated economy, with flexible national factor markets, or the absence of inter-regional redistribution mechanisms possibly taking place through a centrally managed redistribution system, that has prevented China's tremendous growth performance and rising household welfare from being more equally distributed.

The re-conversion of the Northeast region calls today for bold regional initiatives. I have mentioned some of them : strengthening the investment climate to attract new investment, developing greater flexibility in factor markets, using public funds to support adjustment rather than to postpone adjustment, and the key role of safety nets to mitigate the social costs of adjustment. But the preceding argument on inequality suggests that a successful economic restructuring of the Northeast also requires complementary policies at the national level. These are better economic integration and/or inter-provincial redistribution making available the resources needed by restructuring regions. Interestingly enough, these national policies would at the same time dampen and possibly stop or even reverse the trend towards growing inter-regional disparities. This might appear as a new formidable challenge. It is important that it be met, for both efficiency and equity reasons. Given the tremendous dynamism and bold reforms that have characterized economic development of China over the last 25 years, I am confident that such policies will be successfully pursued in the near future.

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<sup>2</sup> This statement refers to inequality between the eastern and southern coastal regions and the rest of the country. On this see Kanbur and Zhang, Fifty years of regional inequality in China : a journey through revolution, reform and openness, Mimeo, Cornell University, May 2001. Note that historians suggest that the same increase in regional inequality may have taken place in the earlier phase of industrialization in the 1920s.



**Figure 1: Overall Investment Climate Score in 23 Chinese Cities**

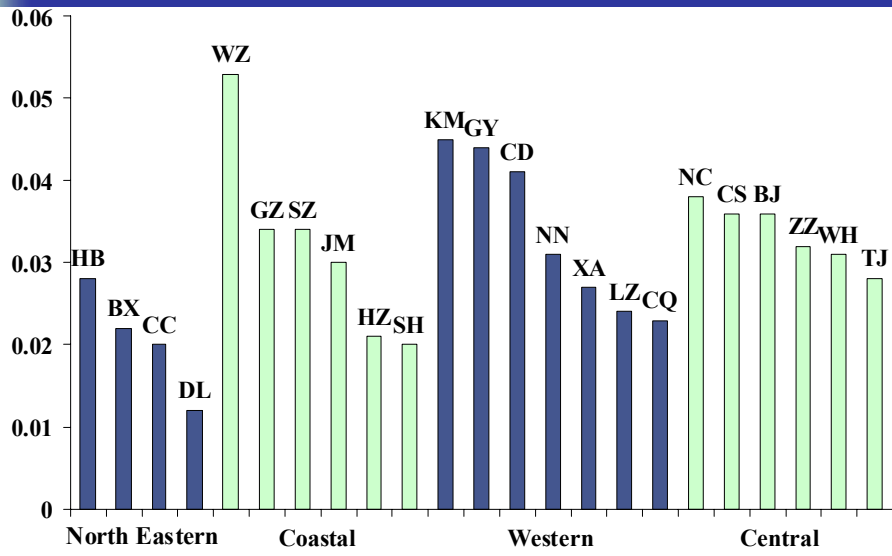
<b>A+</b> Hangzhou Shanghai	<b>A</b> Jiangmen Shenzhen Chongqing Guangzhou	<b>A-</b> <u>Changchun</u> Beijing <u>Dalian</u> Wenzhou
<b>B+</b> Tianjin Nanchang Wuhan	<b>B</b> Chengdu Xi'an Changsha Zhengzhou	<b>B-</b> Nanning <u>Harbin</u> <u>Benxi</u> Kunming Lanzhou Guiyang

Source: World Bank (2003). In Dollar, Shi, Wand and Xu, Improving City Competitiveness through the Investment Climate: ranking 23 Chinese Cities, mimeo

Note: This shows a simple index with equal weights across the ten major IC indicators which was constructed to compare general IC performance in the 23 city sample. All cities are ranged from B minus and A plus, reflecting the fact that all cities in China are doing well compared to international experience. Clearly parts of the Northeast are not doing as well, in particular Benxi and Harbin. Both rank in the lowest category, whereas both Changchun and Dalian are in the A- category reflecting their stronger investment climate.



**Figure 2: Losses due to Poor Infrastructure**  
(Sales share lost to Power/Transport)

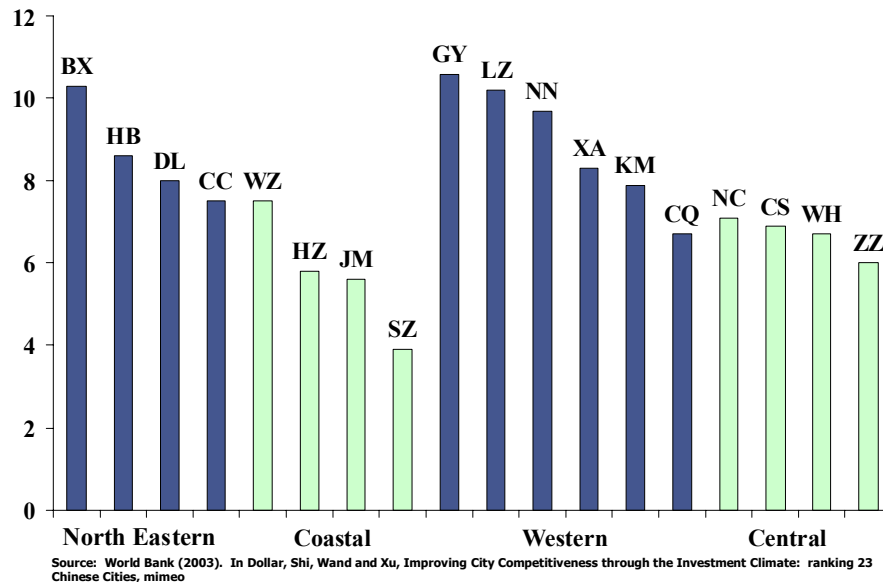


Source: World Bank (2003). In Dollar, Shi, Wand and Xu, Improving City Competitiveness through the Investment Climate: ranking 23 Chinese Cities, mimeo

Note: An important aspect of the investment climate concerns the quality of infrastructure services. This figure shows what firms report as their losses owing to power outages as well as losses owing to transport breakdowns. In general, such losses are low in China compared to other developing countries, such as India or Brazil. But within China there is much variation. The Northeast is seen to have the lowest losses from weak infrastructure, suggesting access to better quality infrastructure. This is an important factor in firm competitiveness which should help regional firms to compete.



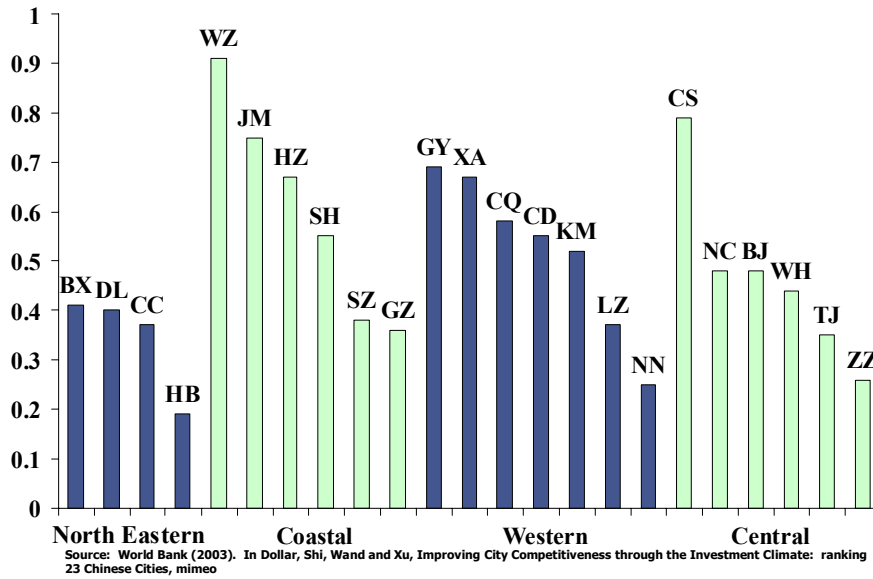
**Figure 3: Effective Tax Rates (Tax rate as a Share of Sales)**



Note: The tax burden on firms appears to be in general moderate in China, but with a wide variation across cities. The Northeast is seen to have a relatively high tax burden, ranging from around 10percent in Benxi to 7.5percent in Changchun, surpassed only by the western cities in the sample. Tax rates are well above levels found in the more dynamic cities of Shenzhen, Jiangmen, or Hangzhou.



Figure 4: Access to Finance (Share of Firms with Loan Access)

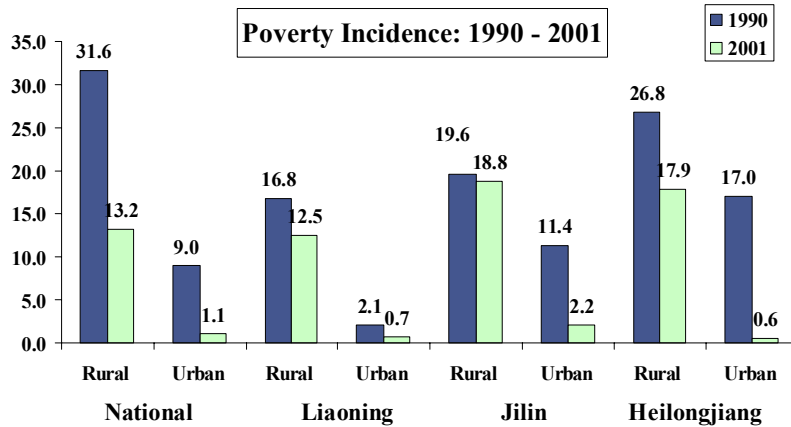


**Note:** Access to finance is likely the main area in which China appears weak relative to many other middle-income countries. Much more of the business and investment in China is done in cash than in most other countries. In many cities fewer than half the firms surveyed have access to loans from the formal financial system. The Northeast in particular does not show high levels of firm access to financial services. Access to loans, as well as the use of trade credit (not shown), is particularly low in Harbin. Dalian and Changchun are close to the average on trade credit but still show low levels of loan access. As Northeastern firms develop and move into more sophisticated product lines, these weaknesses in financial services will likely become more of a hindrance.



**Figure 5: Poverty Incidence through Transition**

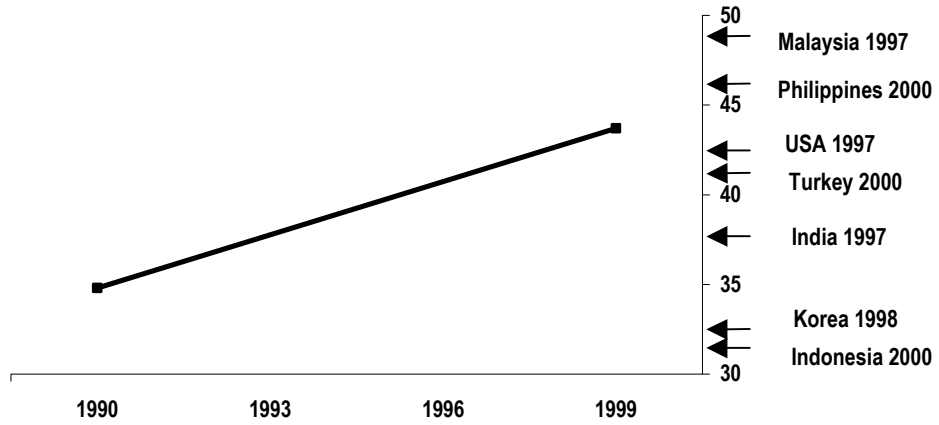
(World Bank poverty estimate)



Source: World Bank, staff estimates

**Note:** This chart shows poverty incidence between 1990 and 2001 nationally and for the three NE provinces using an NBS upper poverty line for vulnerable and poor households. All show a remarkable decline in poverty across the decade, for both rural and urban households, but particularly for urban households. At the national level urban poverty has been almost eliminated, as well as in the Northeast. There has been less progress in reducing rural poverty. In Jilin rural poverty has barely changed since 1990, dropping by less than one percentage point. If a lower poverty line is used, rural poverty appears to have actually increased during the 1990s. This is a remarkable outcome for region where real GDP growth during the 1990s has been high.

Figure 6: Inequality in China, 1990-99 (Gini Coefficient)



Source: China: Promoting Growth with Equity (CEM; Oct 2003), The World Bank

**Note:** Using consumption data and aggregating across rural and urban households, this figure shows the sharp deterioration in distribution in between 1990 and 1999. Income distribution has increased to a level somewhat above that found in the US and Turkey. If China continues on this trend, inequality may worsen and could exacerbate social and economic tensions, particularly with rising inter-regional inequality.