

Regional Differentiation and Growth Momentum

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Under the effects of external shocks and growth transition, most of China's provinces, municipalities and cities experienced slowing economic growth with significant regional differentiation: for instance, Liaoning Province registered an economic growth rate of -1.3% in the first half of 2016 and Shanxi and Heilongjiang grew by less than 6%, while only four provinces and municipalities grew by over 9%, including Tianjin, Jiangxi, Chongqing and Guizhou. In 2016, only four or five provinces may reach or exceed the growth rate of 2015.

According to *Economic Blue Paper Summer Edition: China's Economic Growth Report (2015-2016)*, except that western region outperformed central and eastern regions in terms of development outlook and living standards, China's eastern region outperformed in all other indicators including growth, sustainability and government efficiency. Given the growing regional differentiation, the Chinese government should promote industrial restructuring and create "economic belts" to balance regional development.

I. Regional Development Outlook

Based on our analysis on the development outlook of various Chinese provinces, municipalities and cities during 1990-2016, we believe that despite the structural deceleration of China's economy, the development outlook, economic growth quality and sustainability still improved for various provinces, municipalities and cities. Eastern, central and western regions rank the first to the fifth grade of development outlook respectively. During 1990-2016, China's development outlook

increased by an average of 107.45% and 111.17%, 88.65% and 118.72% for eastern, central and western regions respectively.

The following table lists the ranking of major provinces and municipalities for various indicators:

City	Development outlook	Economic growth	Sustainability	Government efficiency	Living standards
Shanghai	No.1	No.2	No.1	No.3	No.1
Guangdong	No.5	No.1	No.4	-	-
Beijing	No.4	-	No.5	No.1	No.3
Jiangsu	No.2	No.5	No.2	No.4	No.5
Zhejiang	No.3	No.4	No.3	No.2	No.4
Tianjin	-	No.3	-	No.5	No.2

According to the development outlook, Shanghai, Beijing, Jiangsu and Zhejiang have been in the first tier of development over the years. Despite the need for development outlook to improve for all parts of China, central and western regions are falling further behind eastern region in most respects.

II. Industrial Structure and Productivity Led to Regional Disparities

China is currently in a post-industrial stage of growth and successfully crossed the threshold of higher middle-income country. 20% of Chinese provinces have a per capita income above USD 11,000. Thanks to upgrading human capital and development of high-end manufacturing and services, eastern regions achieved successful industrial transition and derived growth from technology progress. However, growth disparities for China's central region and especially western region are rather serious. Industrial relocation from China's eastern to central and western regions is thwarted by the lack of human capital. Due to serious overcapacity of traditional industry, northeastern provinces, Shanxi and Hebei are experiencing slowing growth.

(1) Growing Regional Differentiation

Due to different growth stages and potentials, significant regional disparities have emerged, as evidenced by the catch-up coefficient. Economic growth is generally convergent for advanced eastern region, where growth rate is recovering. Central region also demonstrates a relatively good tendency of growth convergence. However, serious growth disparities confront northeastern provinces and Inner Mongolia, Shanxi and Hebei, which are intensive in heavy-chemical industries. Faced with great pressures of economic transition, these provinces experienced falling growth rates and lack the momentum to catch up with eastern region. Among 11 provinces in China's western part, only three are able to catch up with eastern region, accounting for less than 30%. In recent years, most provinces in China's western part have maintained fairly rapid growth rates. Nevertheless, most of them are small in terms of economic size and vulnerable to risks. In case growth stalls, risks will accumulate and persist.

(2) Regional TFP and Labor Productivity Disparities Are Even More Serious

Since China's reform and opening up in 1978, rapid growth has accompanied TFP and labor productivity improvements characterized by synchronized productivity and economic growth and rising TFP contribution, both of which began to decline after 2008. While short-term repercussions are easier to deal with, the root causes are more intractable. Judged by labor productivity and TFP, regional disparities are even more serious than what GDP figures suggest. The implication is that regional disparities are a reflection of deeper problems of industrial structure.

A. Falling Labor Productivity

During 2008-2015, China's labor productivity underwent slowing growth of labor productivity at 8.16%, which is somewhat below the peak level. This figure is projected to further drop to 6.9% during the 13th Five-year Plan period (2016-2020). Falling growth of labor productivity is primarily due to the shift of resources from secondary industry, where labor productivity grows at 7.4%, to tertiary industry, where labor productivity only grows at 5%.

B. Dwindling TFP Contribution

According to the *Economic Blue Paper (Summer Edition)*, the contribution of China's TFP growth fell from previous 30% to current 16%. If China's potential growth rate is above 6%, TFP contribution should exceed 30% or at least return to historic levels. TFP contribution indicates that China's economy is characterized by a crude pattern of operation.

C. Declining Return to the Scale of Factor Input

Due to decreasing return to the scale of factor input under traditional growth pattern, China cannot complete the deepening of physical and human capital. First, diminishing return to capital and falling capital input due to the lack of technology progress make it difficult to increase capital stock, which prevents capital deepening. Second, stagnant return to human capital due to the lack of labor productivity improvement inhibits human capital deepening. As can be seen from our calculations, due to diminishing return to scale, exogenous factor input growth decelerated and so did the growth of return. Growth of traditional labor input turned negative and capital input declined. Factor-driven growth deriving from scale lost momentum, resulting in diminishing return to scale and slowing economic growth. Traditional growth pattern is also a major culprit for China's growing regional differentiation that aggravated uneven regional development.

III. Industrial Restructuring for Regional Growth

(1) Industrial Restructuring

China's economy is currently in the late stage of industrialization and faced with the problem of serious overcapacity. It is imperative for China to derive new momentum from industrial restructuring and transition towards a pattern of stable growth under efficiency-driven urbanization. Provinces with relatively high per capita income should explore new growth drivers through industrial restructuring, develop high-end manufacturing and increase the share of service sector, particularly modern services. Developing modern services and promoting human capital consumption in the broad sense are two critical engines for China to complete its second-round

transition.

(2) Role of Human Capital and Technology Progress in Promoting Growth

When economic growth reaches an advanced stage, attention should be given to human capital development and technology progress as new drivers of growth. For less developed provinces in China's central and western regions, importance should be attached to the role of investment and industrial relocation in spurring growth. With improving growth, human capital and consumption, China should promote industrial restructuring, develop service sector and shift growth momentum for balanced and stable economic growth.

IV. Creating Economic Belts to Balance Regional Development

Economic deceleration has led to regional differentiation. In particular, provinces heavily dependent on natural resources began to struggle with economic growth difficulties after 2012. In this context, China must coordinate regional development as an important strategy to achieve balanced development.

The first barrier to be eliminated is the government-dominated model of operation. Creation of "economic belts" must be a market-oriented process. Reform of review and approval systems launched by the State Council must be steadfastly carried out to remove barriers and enable market players and private economy to dominate regional economic development. The government should adjust its role by reducing constructive functions and enhancing service functions, and develop a new-type government-business relationship featuring complementary and coordinated administrative and market functions.

Secondly, a closely related strategy is to promote the free and sufficient flow of factors, including people, assets and goods. This requires removing the impediments of household registration system (*hukou*) to the flow of people, barriers of financial system to private credit financing and spatial barriers of uncoordinated regional policies to the flow of goods.

Thirdly, a new type of mechanism for local government cooperation should be established. Creation of "economic belts" requires a high degree of cooperation

among local governments at all levels that transcends local interests and promote integrated regional development.

Fourthly, a new mechanism of evaluation and incentive must be put into place. First and foremost, the evaluation of growth performance solely based on GDP must give way to one that puts premium on environmental protection, social justice and the quality and efficiency of economic growth. Importance should be attached to employment and regional economic integration, where governments at all levels closely cooperate with each other and share the benefits of cooperation.

Fifthly, regions at all levels should establish coordination committee of regional government officials and advisory committee of experts for implementing the new-type intergovernmental cooperation mechanism and jointly formulate their regional development and industrial layout plans.

Lastly, regional coordination committees at all levels must clarify their service and policy functions and rely on market forces for regional economic development. Government must invest in the provision of various public service facilities to create favorable conditions for private capital to invest and strive to strengthen market forces and improve market mechanisms.