

The Intergenerational Content of Current Public Expenditure: Social Spending and Sustainable Growth in China

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Preliminary and incomplete

Comments welcome

1. Introduction

The Chinese economy is growing increasingly unequal. The outstanding long term growth performance has been obtained partly thanks to the very low priority given to all the other policy objectives, including spatial and sector equality. This phenomenon has grown so large in size that in the past few years it triggered a reaction by the Chinese authorities, in fear of social unrest that could undermine the economic performance of the country and its political stability.

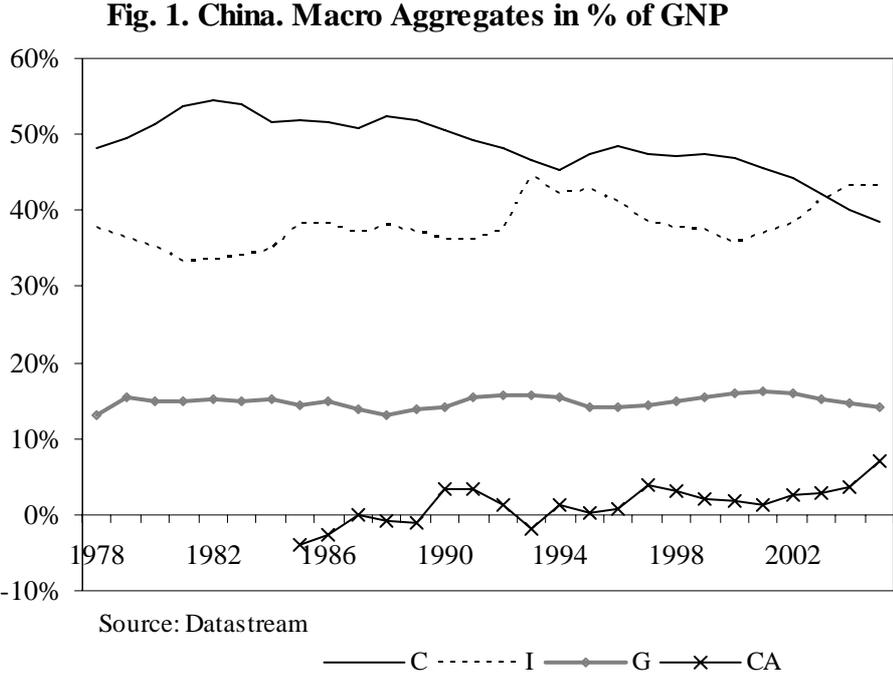
This paper argues that growing inequality should be fought also because it may have long lasting effects in terms of quality of human capital, macroeconomic imbalances, and overall efficiency of the economy. Thus we suggest that current public spending, in particular social spending (health, education etc.), has a strong intergenerational content in that it affects the present distribution of resources among generations, and hence the future level of well being.

The structure of the paper is as follows: Section 2 discusses the well known role of China in today's global macro imbalances, agreeing with the thesis that the excess savings can mostly be attributed to precautionary reasons, that in turn are due to the gradual disruption of the community based social protection system. Section 3 [to be written] discusses the evolution of social spending in the post reform period, and then, in section 4 [to be written] we develop the reasons why current social spending may have strong intergenerational content. Finally, section 5 gives a snapshot of today's attempts to correct the distortions in the provision of health care, based on voluntary adhesion to an insurance

scheme. After discussing why a first assessment of this attempt is rather negative, we conclude by giving some indications about what we believe to be necessary policy and institutional changes.

2. The sources of Excess Savings

In the debate on global imbalances that rages in the academic literature and in the specialized press, the excess expenditure of US consumers and firms is usually contrasted with the “saving glut” (Bernanke (2005)) of other areas of the world, notably East Asian countries. Because of its size, China is usually pointed out as the main example of this world excess saving that helps sustain the current global imbalances. In fact, as figure 1 shows, both the remarkable increase in investment that occurred since the early 1980s and the recent boom of the current account surplus happened thanks to an important reduction



in consumption that from a level above 50% of GNP in the early 1980s declined to the abnormally low level of 38% in 2005.

This aggregate figure hides wide regional and sector variations, along the well known differences in growth between coastal and western provinces, and between rural and urban areas (for a survey see, Lim, Spence and Hausmann (2006)). The savings rate, that in the early 1990s was lower for poorer rural households, is today much lower for urban

households, in spite of an important increase for the latter as well (Kraay (2000; Kuijs (2005)). Contrary to commonsense, today it is the poorest households that save more.

[insert figure with savings evolution by rural/urban household].

While there is some debate as of the causes of this excessive savings (see e.g. He and Cao (2007), the changing behaviour of rural and urban households seems to point to increased income uncertainty and to lower social protection as probable causes for the savings rate, that would hence be substantially precautionary.¹

The literature on savings, risk and insurance (for a survey, see Besley (1995)) documents that developing rural economies experience widespread income risk, and that households adapt their behaviour in order to be protected from this risk, either in the form of self insurance, or of more or less informal risk sharing contracts with other households. Changing patterns in the social contract, notably in the items that play the role of insuring households against risk, quite naturally affect the expected payoffs of households, and hence the intertemporal consumption-saving choices. A recent paper (Pradhan and Wagstaff (2005)) confirms this intuition showing that in Vietnam overall consumption was positively affected by the implementation of a public health insurance scheme.

As the intertemporal decisions of households affect among other things the distribution of current resources between generations, it follows that current spending, notably in social items (education, health, social security), has an important intergenerational content. This content, often neglected, appears to be particularly important in fast growing economies undergoing deep structural change like China.

3. The Evolution of Social Spending During the Reform Period

[To be written along the following outline]

- Focus on Health and Education. Pensions are different. Mainly not a problem of current spending. Make a short summary of Asher *et al.* (2005).
- Description of the pre reform system, based on community and SOE provision of health and education. Job security, very high risk-sharing and income equality (cite Guan (2000))
- Describe trend since 1980 (sources WHO, Guan (2000)):
 - Dismantlement of the previous system
 - Exclusive focus on growth and not distribution

¹ Modigliani and Cao (2004) argue that following the implementation of the one child policy, Chinese households substituted investment in human capital with savings; while somehow exotic, this explanation also points to the essentially precautionary characteristics of today's saving rates.

- Huge increase of private spending on both education and health
- Decentralization caused an increase in regional inequality (Kanbur and Zhang (2005), Qiao, Martinez-Vazquez and Xu (forthcoming), Chou (2007)), both in income and in public goods provision. As a consequence huge differences in education and public health levels (Zhang and Kanbur (2005)).
- Deterioration of public health indicators (Liu, Hsiao and Eggleston (1999), + cite ranking WHO)
- Recent reversal in trend: see section 5
- Conclusion: Fading of the insurance role of the government contributed to the widening of inequality that, in turn, made the absence of social spending more problematic.

4. The intergenerational Content of Current Spending

[to be written]

General starting point: Potential and current output are not unrelated. See on this some of the work on volatility and growth (e.g. Ramey and Ramey (1995)).

From general to particular

- Cyclical stabilisation (low elasticity of public expenditure: (Fatas and Mihov (2001; Andres, Domenech and Fatas (forthcoming)). In a developing country this means reduced volatility of income. With very low level of social protection excessive volatility may be very disruptive of the social and productive structure.
- This could become even more important when in the future the average growth rate will fatally decrease.
- Income stability is good for investment both in human and physical capital. (But, mention the incentive problem linked to excessive income security).
- Schooling duration increases with parent's income (Dehejia and Gatti (2005)). Mangyo (forthcoming) shows that in poor households the food intake of children is directly affected by income increases; this is indirect proof of resources' constraints on the poorest households.
- Higher civil servants' wages would increase the quality of public services, that are complementary to private spending in sustaining present and above all future growth.
- The same holds for expenditure geared to strengthen the legal system

- Increasing the public provision of public goods would free part of the income that is now saved for precaution, for investment in both physical and human capital.
- Recent estimates show a direct impact of health on income and productivity Liu *et al.* (forthcoming).
- Social mobility (“giving to my children better opportunities than I had”) is all the more likely if somehow “counters are reset” at each generation. One of the roles of social spending is a transfer of resources that helps reducing the starting inequality for the new generations.

5. The Role of Social Spending for Sustainable Growth

The beginning of the years 2000s marked an important change in priorities for the Chinese government. The deepening spatial and sector inequality both in income and in the provision of public goods was eventually perceived as a potential cause of excessive imbalances, with possible effects on social stability and overall growth. In October 2002, the first China National Rural Health Conference was held in Beijing, and a set of reforms in the provision of health care was announced. (Liu and Rao (2006), Wagstaff *et al.* (2007)). The scheme is now in a pilot phase, the coverage of all counties is predicted to be completed by 2008.

The New Cooperative Medical System (NCMS) is based on voluntary adhesion. The unit of the scheme is the county instead than the village, increasing the scale of each unit for better risk pooling and economies of scale in organization. The level of discretion of each county is very high, from coverage to cost sharing, to fees, etc., in observance to the traditional principle of decentralization in health policy.

The program is based on a flat per-person contribution, that is subsidized up to 40 renminbi for the poorest households (the burden is shared equally by the provincial and the central government).

A voluntary insurance scheme is confronted to all the typical asymmetric information problems associated with the provision of public goods. These concerns are reinforced by the wide inequalities in income level and in needs in the recipient population, and by the diversity in economic structures among provinces. Even if it is too soon to assess the effectiveness of the new system, an attempt has been made by Wagstaff and Yu (2007), and Wagstaff *et al.* (2007). Their first remark is that the budget of the NCMS is too small to significantly affect households’ out-of-pocket spending. The contribution per capita, including the subsidies, is around 20% of total per capita rural health spending; furthermore, the large deductibles, and high coinsurance rates make copayments large. The ensuing excessive financial burden on the insured could induce the poor to avoid enrolling

in the scheme, thus letting out of medical coverage the group that is supposed to be the main beneficiary of the program (a finding that is hardly surprising, see also Jalan and Ravallion (1999) and Wang and Rosenman (forthcoming)). By looking at the urban program, Lindelow and Wagstaff (2005) further argue that, because of the distortions in the pricing mechanism and in the widespread practice of fee-per-service reimbursement, higher end care is more profitable and hence over-provided with respect to basic health services (see also Eggleston *et al.* (2006)). As a consequence, actual spending by households may even end up increasing.

The preliminary assessment of Wagstaff *et al.* (2007) at any rate gives mixed results. The cost per case remained unchanged in spite of increased ownership of expensive equipment. On the other hand, enrolment by the poor was as expected low, as well as their access to health care. Furthermore, they report no evidence of decreases out-of-pocket expenditure.

As mentioned above, these results are hardly surprising. All the standard problems incurred in by insurance schemes for the provisions of public goods are likely to be exacerbated in presence of strong inequalities and high income uncertainty.

This overview seems to suggest three main policy conclusions, to be further explored:

1. Larger attention to equality should be paid, in order to obtain income stabilization and provide private households with a more certain environment (see also Kuijs and Wang (2006)).
2. An effective solution to the worsening conditions in health provision seems to be the gradual move towards universal health coverage. Collective insurance seems to be the only way to reduce the huge differences in access to health care. This does not mean that the provision of health services should necessarily be public (see Eggleston *et al.* (2006) for pros and cons of the different frameworks).
3. The spatial inequality embedded in the process of decentralization has been a major cause for increased inequality in income and in social conditions. (Qiao, Martinez-Vazquez and Xu (forthcoming)). This calls for a central management of the health system, and/or for a system of strong interprovincial transfers (Chou (2007) documents a strong correlation between provincial government deficit and health care provision). In both cases problems of free riding and moral hazard should be appropriately taken into account.

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