COMMENTARY CHINA FINANCIAL MARKETS

Will China’s Common Prosperity Upgrade Dual Circulation?

Chinese leaders know that they want to discontinue the country’s existing growth model, but they haven’t yet landed on what the sustainable alternatives are. Beijing’s new common prosperity policy will only help shift domestic demand at the margins, but a full-fledged rebalancing will require a more radical transformation.

By **Michael Pettis**
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In a September 2021 interview, Logan Wright of the Rhodium Group came up with an especially felicitous way of describing the economic conundrum Beijing faces. "I think there's generally more coherence right now in Beijing about the critique of China's current growth model," he **explained**, "rather than coherence around what that alternative would really look like."

I agree. Over the past decade or more, Beijing has developed a clear understanding of the limitations of its once highly successful growth model. Chinese leaders recognize that the country's reliance on high savings to fund high investment no longer made sense once China had closed the enormous gap that had emerged by the late 1970s between its moderately high investment needs and its extremely low investment level. Once that gap was closed and even reversed, sometime in the mid-2000s, an extraordinarily high savings rate could no longer create sustainable demand by funding productive investment.

But because China's high savings rate was the obverse of an extraordinarily low consumption rate, Beijing could not allow investment growth to decline without causing a sharp decline in GDP growth. And yet at the highest levels of Chinese economic policymaking circles, there is a recognition that nonproductive investment has become a serious problem. In an **important July 2021 essay** by Chinese leader Xi Jinping on the country's "new development dynamic," for example, he demanded that China improve the quality and returns of economic growth and that the country should begin to pursue "genuine rather than inflated GDP growth."

In theory, it would be possible to accomplish this by shifting a huge amount of investment with low or negative economic returns into high-productivity sectors of the new economy. But Beijing has been trying unsuccessfully to do this for years, and for reasons I have discussed **elsewhere**, this is likely to be almost an arithmetical impossibility. That is why Chinese policymakers largely recognize that China must transform its growth model into one in which the consumption share of GDP rises substantially. But while Chinese policymakers understand the limitations of the country's current growth model, they have failed to present a coherent alternative.

To explain what I mean, it helps to go back a little. In May 2020, the Chinese government introduced the dual circulation development model that has since guided many of the policies that have been implemented or announced.

According to the dual circulation model, China plans to emphasize both growing exports (international circulation) and expanded domestic demand, powered mainly by rising consumption (internal circulation), with the two reinforcing each other. The idea is that expanding demand for Chinese-manufactured products and exports as well as domestic consumption would support and strengthen China's manufacturing base which, for Beijing, is the engine of China's development success.

The Contradiction in the Dual Circulation Model

But as I **explained** in an August 2020 *Financial Times* op-ed, there is a contradiction at the heart of the dual circulation formulation. China's export competitiveness—like that of Germany, Japan, and other persistent surplus-running countries—depends on ensuring that workers are allocated, whether by wages or social transfers, a relatively low share of what they produce. It is no mere coincidence that in all the countries with high persistent surpluses workers are paid less relative to their productivity levels than the workers of their trade partners. China's export strength, as Matthew C. Klein and I explained in **our 2020 book**, *Trade Wars Are Class Wars*, depends at least in part on the low share workers retain of what they produce.

But China's low domestic consumption rates—among the lowest in history—are mainly the consequence of Chinese households **retaining** one of the lowest shares of GDP on record. This means that conditions that strengthen consumption result in less competitive exports, and vice versa. In fact, in the fifteen months since Beijing proposed the dual circulation model, the export share of China's GDP has surged, while the consumption share has lagged. Again, this is no mere coincidence: weak income growth relative to GDP has increased China's export competitiveness while helping to repress domestic consumption.

Perhaps it was partly to address this contradiction that Beijing recently modified its development strategy by reintroducing and refurbishing an old phrase: "common prosperity." While there is still much confusion about what this slogan might mean, and it will probably be months before a consensus emerges, a **September 2021 *China Daily* article** describes it approvingly as including "the adjustment of overly high incomes . . . more help for low-income groups . . . and the expansion of the middle-income group."

The goal of the common prosperity campaign, it seems, is to rebalance income levels through transfers from those who are rich to those who are not. But rather than doing so by raising wages—which would undermine export competitiveness in a country in which the **export sector** comprises a disproportionately large share of the economy—Beijing will focus partly on fiscal transfers and mainly on what it calls tertiary distribution. In Chinese economic jargon, primary distribution refers to wages and direct income as a source of disposable household income, whereas secondary distribution refers to fiscal transfers to households, and tertiary distribution—a little bizarrely—consists of donations by businesses and wealthy individuals.

The Limitations of Common Prosperity

Rather than raise wages, in other words, Beijing will pass on what it deems to be the excess profits of businesses and the wealthy to middle- and working-class Chinese households in the form of fiscal transfers and donations from businesses and the wealthy. In this way, the Chinese government can keep domestic wages competitively low, while at the same time raising overall household income levels by effectively delivering to workers and the middle classes a higher share of business profits.

In principle, this approach could help strengthen domestic consumption without undermining export competitiveness, but there are at least three reasons to be cautious. First, donations by foundations set up by Chinese businesses and wealthy individuals **accounted for** roughly 0.2 percent of GDP in 2017. (By comparison, charitable giving in the United States **amounted to** around 2.3 percent of GDP in 2020.) Not only is China's figure very low in and of itself, and very low compared to those of other major economies, but most of this giving in China is not used to boost household income directly but rather is donated to universities and think tanks and used to fund indirect support for poverty alleviation and healthcare. Giving in China mostly goes to support the supply side of the economy, in other words, rather than the demand side. For this to represent more than marginal income rebalancing would require not just a substantial increase in the amount of private donations but, more importantly, a significant restructuring of the form of giving.

Second, by forcing the private sector to bear the brunt of the adjustment costs for rebalancing Chinese income distribution, the common prosperity campaign risks undermining the dynamism of the Chinese economy. This is something several prominent Chinese economists and policy advisers have already warned about.

But the third reason is by far the most important one for why it would be prudent to be cautious about the projected success of the common prosperity campaign: Beijing may be seeking to resolve Western forms of income distortion instead of Chinese forms of income distortion in China's very different economic context.

In the West, where household income typically represents 70-80 percent of GDP, the main income distortions are in the unequal distribution of the benefits of growth between those who are rich and those who are not. In China, however, households retain a much smaller share, roughly 55 percent of GDP. While income inequality is certainly a problem in China, the country's low consumption rate isn't primarily caused by an unequal distribution of income among households. It is mainly caused by the low household share of GDP, itself a function of the country's very high government share of GDP, which is recycled into investment rather than used, **as in other countries** with high government shares of GDP, to support demand-side social programs to benefit households.

An Incoherent Alternative

That's the problem with trying to address Western-style income inequality in China, where income inequality is a less significant contributor to the country's major income distortions. Until Beijing begins to transfer income from local governments to households—either directly, or indirectly in the form of social welfare programs—it will be impossible for consumption to play a more normal role in driving the next stage of Chinese growth. But the political implications—and the required institutional changes—are probably well beyond any consensus Beijing and local provincial capitals have been able to reach. Among other things, such changes would require a huge reduction in the capacity of local governments to subsidize and support local production and investment.

This is what I mean by the lack of coherence concerning the sustainable alternative to China’s current growth model. The politics of income transfers from the government to households likely will be even harder to absorb institutionally than the politics of income transfers from the wealthy. The former will require (among other things) an enormous increase in the ratio of household income to government income and an equivalent reduction in the capacity of local governments to intervene in and direct the economy. It is hard to imagine that a relative transfer of this magnitude would not come with an equivalent relative transfer of political power.

By the way, it is important to recognize that this would be much less of a problem for the central government in Beijing than it might be for local governments. The central government’s relative power might actually increase as the relative power of local governments diminishes. But local elites who benefit from the power and largesse of local governments are likely to strongly resist steps that would result in them having such a diminished role.

The math is otherwise quite straightforward. As long as Chinese government officials and businesses retain and invest a disproportionately large share of Chinese income (while households correspondingly retain a disproportionately low share), the only sustainable way to rebalance domestic demand in the direction of more consumption requires that either the Chinese government or Chinese businesses absorb the bulk of the transfers to the household sector. If businesses have to absorb the costs, Beijing risks derailing China’s engine of growth. That leaves the government as the only option. Until Beijing recognizes that it cannot rebalance its economy without transfers from local governments to that it cannot rebalance its economy without transfers from local governments to ordinary households, it does not have a coherent vision of a sustainable alternative to its current economic growth model.

Aside from this blog, I write a monthly newsletter that focuses especially on global imbalances and the Chinese economy. Those who would like a subscription to the newsletter should write to me at chinfinpettis@yahoo.com, stating their affiliations. My Twitter handle is @michaelxpettis.