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Asia: the Role of Mega-Projects

The Capitalist Disease: Infrastructure's Windfalls

EVERY SOCIETY needs capital-and-culture-intensive infrastructure that supports its population. Private enterprise in the modern economy could not survive without those public goods. Entrepreneurs need the back-up of services ranging from public health to the rule of law. But in the competitive market, a feed-back mechanism is at work which subverts the intended outcomes of these shared services.

Competition delivers optimum efficiency *only if the distribution of income also conforms to the principles of justice.* By this, we mean that the value generated by the producers of goods and services should be shared by those who engage in its production. Trouble starts when part of the value leaks into the hands of those whom we elsewhere designate 'Predators'.[1]

In the capitalist economy, most social and economic problems stem from the fact that the pricing mechanism is legally and institutionally constrained from functioning either efficiently or fairly. Specifically, the problem is located in the system of public prices – government's taxes – which are a covert way of redistributing income from the *poor to the rich*. This is how it happens: everyone pays taxes when goods and services are consumed, when transactions in the capital markets are undertaken, or when wages and salaries are earned. That tax revenue is pooled by government and much of it is used to fund infrastructure and services which raise the productivity of the economy. This ought to be good news for everyone. In fact, it is bad news, because the net gains are crystallised into land values. This part of economic value, created by society's progress, is taken by the owners of land, including home-owners. So everyone's taxes, including those of the poor who do not own their homes or other land, are used to create value which is captured by the relatively rich, who own land, for the most part under their houses. In other words, the wealthy effectively receive back the money they pay in taxes.[2]

- If land values – as annual flows of rent – were recycled back into the public purse, they would fund the infrastructure needed to operate an efficient economy and a fair society.
- If land values are privately appropriated, they cannot be consumed or invested by the community. This obliges people who work for their living to pay taxes to fund the infrastructure that profits the landowners.

In the latter case the principle of fairness is abused by government. But people are also burdened with taxes that damage the incentives to work, save and invest in productive enterprises. This maldistribution from low income earners to high income asset owners has been documented for the UK.[3]

The lessons for neo-colonised countries are vital. The scale of the challenges they face today are magnified far beyond anything that confronted governments in Europe at the dawn of the Industrial Revolution (see box below). Where is the equal common birthright of every citizen of the world? But the opportunities are also enormous – if the problems are converted by good governance into capital formation at an accelerated pace.

Triple Whammy

THE Asia-Pacific region is experiencing the triple dynamics of economic growth, urbanisation and poverty. It accounts for 34% of the global urban population, and is home to over 40% of slum dwellers. India has nearly 62m people living in slums and squatter settlements.*

* Kumari Selja, India's Minister of Housing and Urban Poverty Alleviation (December 15, 2006)

The construction industry, for example, could play a leading role in speeding up economic growth within a balanced social framework. The extent of the need for new dwellings in Asia is difficult to grasp. India alone will need 24m more homes over the next decade. But whether builders can contribute to net gains from capital formation and consumer satisfaction depends on the kind of pricing mechanism that is employed to deliver growth.

At present, the prospects are not good. The Indian government (in 2008) is committed to a Washington Consensusbased strategy which emphasises foreign investment in real estate, and the formation of "secondary mortgage markets and securitisation and pro-poor partnerships where 10-15% of land is earmarked for providing 20-25% dwellings for the poor".[4] This is the confused conflation of Welfare State with the de Soto model of property rights.

The financial model on which India is basing its hopes will perpetuate the boom/busts that are endemic in the capitalist economy.[5] But the people of India cannot afford to lose time or waste resources on avoidable recessions. For all her vaunted achievements in recent years, "in 2003 there were hardly 5m workers in organised manufacturing out of a labour force of over 350m!"[6]

Asia could drive her economies to new plateaux of sustainable growth by making infrastructure available to the majority of the urbanised population who live in the smaller towns and cities. The challenge is to halt the exodus of capital resources, which "tend to seek the better infrastructure of existing large cities".[7] There is one way only to prevent this exodus: remove the attractions of windfall gains from land, which are larger in the mega-cities. This (as we explain in Part 3) would create the 'level playing field' between people, so that lopsided development is avoided.

China is the one country in Asia that has retained the opportunity to accomplish this by applying in a consistent way the rules of the market economy. Will the Communist Party, which has not had its power wrested from it by a Yeltsin, learn the secrets of inclusive prosperity? Or will it hand the nation's natural riches to their version of the Russian oligarchs?

China: the Teachings of Dr. Sun

JEFFREY SACHS arrived in China in 1992. He found that the Communist Party had retained its grip on the political process over the previous 20 years, and was not willing to be beguiled by Western doctrines.

China had experimented with ways to embrace market mechanisms for producing wealth without abandoning socialist sentiments. How sincere the Maoist doctrine was in relation to the values of equality and brotherhood (millions died during the Cultural Revolution) is for history to determine. But the Politburo that was engineering change was cautious.

That did not inhibit Jeffrey Sachs. He launched himself into regular visits as an advisor to economic scholars who had been educated in the West. He graduated to advisor to senior government officials on issues like the development of remote Western provinces. China needed a model of development, but did it need advice that had helped to catapult Russia into economic and social disaster? Could she draw on home-grown lessons that identified ways to establish an efficient market economy that was fair to everyone?

The foundations of such a philosophy were laid by Sun Yat-Sen (1866–1925). He led the revolutionary Kuomintang forces that overthrew the Manchus, the last imperial dynasty. His manifesto, *San Min Chu I* ('Three Principles of the People'), distilled classical economic science from the West with the ancient wisdom of China (see box over).

One of the key planks of Dr. Sun's reform was to combine land tenure with a public finance system that drew its revenue from rent. This could be achieved if the state enacted two regulations: "First, that it will collect taxes according to the declared value (by landowners) of the land; second that it can also buy the land at the same price". Dr. Sun's formula trapped the land owners. If they under-assessed the value of their land, to reduce their tax liability, the state could purchase their property for what would be less than its market price.

When asked by American reporters for the origins of his fiscal philosophy, Dr. Sun replied: "The teaching of your single taxer, Henry George, will be the basis of our programme of reform. The land tax as the only means of supporting the government is an infinitely just, reasonable, and equitably distributed tax".[8]

Dr. Sun pursued the policy to its logical conclusion, advocating that "after land values have been fixed, we should have a regulation by law that from that year on, all increases in land values...shall revert to the community". This was the strategy commended by John Stuart Mill, who proposed to leave existing rents with their owners. Eventually, rents would grow to the point where it would not be necessary to tax labour and capital. This policy would have launched China on the road to prosperity without the need for the traumatic experiment in communism.[9]

But if the lessons of the pre-Mao home-grown philosophy needed to be complemented, the Politburo in present-day Beijing could draw on the example of Taiwan. Here was a Chinese people who, out of necessity, developed a strategy that delivered prosperity and the prototype for a new player on the global scene – the Asian Tiger. The people who had followed General Chiang Kai-shek into exile on Formosa took with them the teachings of their first leader, Dr. Sun Yat-Sen.

Three Principles of the People

DR. SUN combined the principle that "each tiller of the soil shall possess his own fields" with the modernising need for capital investment and the scientific rotation of crops.* In 1924, Dr. Sun's Kuomintang political party fleshed out the detail of its plan to reduce the share of rents taken by landlords and to consolidate the rights of tenant farmers.** In the industrial sector, the Kuomintang manifesto pledged to promulgate laws to elevate the status of industrial workers, including the creation of factory councils to facilitate consultation between employers and employees – the model of works councils that were so successful in Germany after World War II.

Mao's Communist Party, which ultimately vanquished the Kuomintang, acknowledged *San Min Chu I* but favoured the economics of *Das Kapital*. At the Communist Party's 17th Party Congress in 2007, however, President Hu Jintao conceded that Mao's theory of class struggle was erroneous; but offered no insight into the errors in the hybrid model which they were developing, which attempts to merge communism with capitalism.

The modern Chinese model is enriching the few in the same way as has occurred in capitalist countries, for the same reason – the failure to treat rent as public revenue. Thus, Hu's doctrine – "To realise social equity and justice is the Chinese Communists' consistent position" – was contradicted by the emergence of 106 billionaires in China in 2007, a leap from just one such rich person in 2003,† while peasants in the countryside rioted in protest against state-sponsored land grabs.

*Yat Sen (1929) pp. 456-464 **Tawney (1932) p. 83, n. 1 † Sheridan (2007)

The Statute for the Equalisation of Urban Land Rights was enacted in 1954 to complement the land-to-the-tiller policy. Chiang's government structured its compensation to landlords so that the latter were obliged to invest their money in urban industrial enterprises. In addition, government raised a significant portion of state revenue from the rent of land. These policies laid the foundations from which Taiwan's take-off was launched. Further measures, such as the Land Tax Law (1977), provided stronger regulatory and enforcement powers for land-related charges.

The Opportunity Cost of the Command Economy		
	People's Republic of China	*Taiwan*
GDP (PPP) per capita ($)	5,896	27,600*
Unemployment (%)	9.9	4.4
Government spending (% of GDP)	20.8	15.3
Top Income Tax Rate (%)	45	40
Top Corporate Tax Rate (%)	33	25

Source: Kane, Holmes and O'Grady (2007)
* 2005 (purchasing power parity)

The above table compares some of the vital statistics of the two Chinas. Suitably interpreted, it might lay the basis for a counter-factual history. *What if*, instead of choosing the command economy prescribed by Marx, Chairman Mao had adopted Dr. Sun's doctrines in 1949 (the year he drove Chiang's nationalists from the mainland)? The difference between the countries in *per capita* GDP gives us a sense of the wealth that was denied the people of the mainland. *If* the warlords had desisted; *if* Mao had resisted Marx's theory of the inevitability of socialism; *if* Dr. Sun's programme had been instituted – since 1949, the people of China would have enjoyed material prosperity on a wondrous scale.[10]

But Beijing could also draw on the lessons from Hong Kong – the single most successful market economy in the free world. (Hong Kong is reviewed in chapter 8.) Its fiscal philosophy sympathetically reflected the norms of social solidarity and individual prosperity that were supposed to be at the heart of Marxist ideology. Thus, the overwhelming evidence, from Sun's teachings and the records of Taiwan and Hong Kong, directs attention to the one issue that was curiously absent from the teachings of Jeffrey Sachs: the need to locate the tenure-and-tax nexus at the heart of any strategy for transforming the socialist economy, or for eliminating poverty.

During the early 1990s, Sachs observed the trends that were to lead up to the passage of China's Real Rights Law in 2007, and he examined Western interpretations of China's model. He noted that the commune system in agriculture was dismantled in favour of incentives to farmers to increase their output. "This was shock therapy *par excellence*," he gleefully noted.[11] Peasants were also freed to move into the towns where capital could be invested for private profit. Enterprise zones were designated which provided tax incentives to investors.

> The rest, as they say, is history. These zones took off. They combined very low-cost labour, availability of international technology, and an increasing and eventual torrent of investment funds, both from domestic savings, but increasingly in the 1990s, foreign direct investment.[12]

Sachs does not identify the flaw in this model. The evidence was abundantly available in Britain and the United States, where enterprise zones were deployed by the Thatcher and Reagan administrations. The result was disproportionate rewards for land owners, who pocketed the tax incentives that were supposed to reward investors who created jobs.

In other words, enterprise zones were one example of a generic process in which rent-seekers drain the economy of the surplus for their private benefit, at the expense of everyone else.

In China, the result was unintended: people who occupied land in the coastal ports were able to privatise the rents because the state failed to collect this revenue to fund public services. In 2007, while GDP grew at an annual rate of almost 12%, government struggled to control inflation driven by the property sector.

China's market-based achievements were impressive. In the 20 years to 2001, 400m people were elevated out of poverty. But by allowing rental income to be privatised by default she is storing up the deep-seated problems which in the past have led to violent social upheavals.

Progress against absolute poverty began to slow in the latter half of the 1990s. Having swapped Marx for the market, the communists were exposed to the capitalist disease which creates a permanent class of outcasts.

Nevertheless, the Communist Party's institutional approach to the mixed political-and-economic model preserved the opportunity to push reforms further in the direction of Dr. Sun than Dr. Sachs. In 2007, the National People's Congress passed the Real Rights Law. Western commentators emphasised the legal protection for private property. The law did, indeed, affirm the private ownership of goods and man-made capital. But it resolutely affirmed that land and nature's resources would remain in the public domain. Individuals were free to hold secure land-use rights. Fatally, however, the law failed to enshrine the reciprocal of that legal right, namely, the obligation to pay the market rent into the public purse. One consequence was the incentive to corruption by state officials. In 2006, over 8,300 party members were punished for accepting bribes.[13]

Statecraft and Social Funding

THERE IS not a corner of Asia that has not been torn by post-colonial Marxist-inspired conflict. The command economy has now been abandoned, and good riddance to it, according to Jeffrey Sachs. The central state has outlived its usefulness, he tells us.

> Why? China's centralised apparatus, which extends over such a large area, is not compatible with the dynamism of a decentralised and diverse market economy and market-based society, which depends on migration, multiple bases of power and wealth, and regional diversity. This dynamism is already putting huge strains on Chinese statecraft.[14]

A new model of statecraft was needed compatible with the logic of markets. But an incomplete model was offered to his audiences in China when Sachs lectured them on the need to empower provincial and local governments. Experiment was needed that allowed for "diversity, creating a more complex division of labour, and enabling mobility – in short, to see what works".[15]

But there was no need for China's administrators to re-invent the wheel. We know what does *not* work in the market economy; and that optimum results are achieved when the pricing mechanism distinguishes rent from the wages of labour and the profits of capital. This model was not elaborated by Sachs, which is why we do not share his optimism that China would "end poverty in the 21st century".[16] *Neither Britain nor the United States has terminated poverty despite two centuries of market-based growth.* Why should China succeed where they have failed?

But China – indeed, the rest of Asia – *could* abolish poverty by employing the statecraft that synchronises good governance with the rules that motivate people in the productive economy. The scale of the challenges are enormous, but they could be turned into solutions if the people were liberated to work in communities that excluded the exploitation by the rent-seekers. The state has a crucial role to play as a partner with the people in the provision of infrastructure. From international highway networks for the millions who will migrate into cities in the next few decades (and will need new homes), to the renewal of water and sewerage systems – they all require the commitment of vast resources. Those resources would be generated by the infrastructural services themselves. The success with which Asia drives her economies to prosperity on the back of such mega-projects depends entirely on what happens to the gains from these investments.

Infrastructure need not be a financial burden on anyone. It offers *self*-funding opportunities for raising the quality of the lives of everyone. The author has described the technical terms for this funding process in *Wheels of Fortune*.[17]

So Asian governments need not depend on foreign financial institutions for the money to initiate the projects that would deliver economies of scale and accelerate the redevelopment of low income countries. By declaring in advance that the infrastructure would be funded out of the rents which they created, bankers, including those in the West, would be aware that the projects were viable ('white elephant' investments are excluded from this category). Those bankers would be willing to provide funding, even though rents would be beyond their reach. Western technical expertise and capital would be subordinated to the common good of host countries.

Once the principle of who-gets-what is clarified, the pricing mechanism would take care of the practical problem of dividing rents from the share that goes to labour and capital. This funding model is compatible with the devolution of decision-making, so that people may express their preferences on what meets their needs. In fact, it is only when people-power is released at the local level that the maximum rents can be generated. In other words, the financial viability of an infrastructure project is contingent on its providing services for which people are willing to pay.

This is the statecraft which the Asian economies could initiate. The lessons would be quickly learnt by redeveloping countries on other continents.