It's All in the Execution: Struggling with the Reform Agenda

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China's authoritative Leadership Small Groups have met and struggled to define priorities within China's broad reform agenda. The issue of government privileges is in the forefront, as state executive compensation faces questions, and SASAC launches a reform initiative seemingly designed to maintain its own privileges and position. Still, multiple decentralized initiatives keep the reform movement alive.

China's leaders aren't taking much of a summer vacation this year. On Monday, August 18, two of China's Leadership Small Groups met, back to back. In the morning, the Comprehensively Deepen Reform Leadership Small Group (hereafter DRLSG or Reform Small Group) met, and in the afternoon, the Finance and Economics Leadership Small Group (FELSG).[1] On Wednesday, August 20, all seven members of the Standing Committee of the Politburo attended a commemoration of the 110th anniversary of the birth of Deng Xiaoping.[2] At the end of the next week, the full Politburo met and approved new regulations on managerial compensation in state firms.[3] However, the sudden burst of activity has not necessarily been accompanied by serious progress in economic reform. Indeed, the issues addressed raised continuing doubts about the priorities of the reform agenda and the order in which complex issues were being tackled.

Liu Yunshan Joins the Finance and Economics Leadership Small Group

There are only a few reports on the afternoon FELSG meeting, the seventh in this administration. As far as these published reports indicate, the afternoon FELSG meeting was taken up solely with a discussion of technology policy. The Ministry of Science and Technology and the National Development and Reform Commission delivered reports; Xi Jinping gave a speech; and there was discussion. It's not clear whether anything substantial came of the meeting.[4] Given the limited information, I will not discuss the meeting further in this note.

The most significant aspect of the news coverage was the revelation that Liu Yunshan attended the meeting and was a member of the FELSG. This was a surprise: the previous meeting of the FELSG had been the first such meeting ever publicized in real time. On that occasion, the membership of the group had been revealed indirectly when CCTV cameras panned across the meeting room. Liu Yunshan was not there (he was in Finland at the time). Including Liu Yunshan, the FELSG now has four Standing Committee members in its ranks (Xi, Liu, Li Keqiang, and Zhang Gaoli). What makes this surprising, however, is that Liu Yunshan has no obvious economic jobs. As head of the Party Secretariat, and in control of propaganda, ideology, and party organization, Liu Yunshan is already an extremely powerful figure, but not one with control of any purely economic issues.[5] Many had already noted the significance of Liu's membership in the

Reform Small Group constituted at the Third Plenum last year—in fact he is the vice-head. This membership brings an additional "party" voice into the economic reform arena, but it at least makes sense in terms of the exceptionally broad definition of reform adopted at the Third Plenum. Indeed, the Reform Small Group on August 18 took up the creation of new types of media organizations, so Liu would have naturally taken the lead on that issue. However, Liu's membership in the FELSG makes little sense in terms of the traditional division of responsibility, under which economic issues are led by the premier and the State Council more broadly. Thus, Liu's membership seems to reflect increasing direct party oversight of economic issues, and cements Liu's position as one of the more powerful members of the Standing Committee. Indeed, Liu may today be the second most powerful person in China after Xi Jinping.

The Reform Leadership Small Group

The morning meeting, on August 18, 2014, of the "Comprehensively Deepen Reform Leadership Small Group" was the group's fourth. Two kinds of documents were discussed: those related to the group's own ongoing work, and policy documents related to specific areas. In the first category, the group heard a report on reform implementation during the first half of 2014, and then, more crucially, a seven-year plan for carrying out reforms over the next seven years, "The 2014–2020 Plan for Implementing Important Reform Initiatives of the Third Plenum of the Party's 18th Party Congress." (党的十八届三中全会重要改革举措实施规划 [2014－2020年]). Unfortunately, this important document has not been publicly released. There was a notable absence of self-congratulation in the brief report of the meeting. While it would be nice to believe that the new document represents a clear "road map" for reform, this seems unlikely: there was already a 2014 plan for reform activities, and a document assigning responsibility for specific reform initiatives to different agencies (as discussed in *CLM* 44). At first glance, the new document appears to be just one more in this series of declarations about what reformists intend to do when reforms really gain momentum.

This impression was intensified by the list of specific policy documents the meeting considered. The meeting discussed managerial compensation in state-owned enterprises, changes to the college entrance examination system, and the integration of old and new media companies. Some of these are discussed below, but we can note at the outset that these are *not* the most critical issues in the reform area generally, and especially not in the economic reform area. More tellingly, it is not even clear that these are reforms at all: some of them look more like ordinary policy-making or bureaucratic reshuffling. A headline in the *People's Daily* overseas edition said the meeting displayed "logic, priorities, rules and urgency."[6] The way to read this is probably to conclude that people are increasingly worried that reform implementation is *not* displaying priority or urgency, that concern is growing that the reform outcomes so far have been rather meager, and that the Reform Small Group is stepping up efforts to increase urgency and assign priority to specific initiatives in order to reassure the public that reform process is on track..

We can see the Reform Small Group as being caught between two competing conceptions of the reform process and their role in it. Both conceptions derive in part from the vast scope of the reform program and the many areas included. In the first conception, it is clearly unrealistic to try to plan and organize the whole thing, and the most reformers can do is touch off an unruly process of change, and then try to shape it as it occurs. Indeed, reformers have repeatedly said that the strategy of the Reform Small Group is to "approve specific reforms as they mature," that is, as specialized groups are able to hammer out specific programs and build a rough consensus around them, the Reform Small Group will "seal the deal" and approve a final version. In this sense, the Reform Small Group—and especially the professional staff that make up its office—act as "honest brokers," channeling good reforms up to the ultimate decision-makers. This approach can work, but risks degenerating into a laundry list of reform items, popping up in no particular order. This danger is especially great since the list of items to reform is, to a certain extent, problem-driven and thus potentially infinite.

What determines whether a problem is significant enough to muscle its way into the main reform agenda? Indeed, at the second meeting of the Reform Small Group, Xi himself said, "with respect to each specific reform responsibility, we must stay oriented to the big problems that influence economic and social development; start with the obvious problems that obstruct economic and social development and incite strong reactions from the masses; and work hard to break down systemic barriers."[7] Taken seriously, this approach introduces a populist element into reform policy-making, tackling those problems that attract the most attention and concern, that generate the most traffic on *weibo*. The agenda of the most recent Reform Small Group meeting displays a a tendency in this direction: By addressing state college entrance procedures, the Reform Small Group is certainly responding to an area that incites strong reactions among the masses, rather than one that is fundamental to the broader reform effort.

In the second, competing conception of the reform process, reformers must create a "top-level design" for certain aspects of the reform. That means setting priorities among competing reforms and a sequence for interrelated reforms. In some economic areas, only certain sequences of activities can make economic sense and avoid excessive risk, for example, when specific institutions or mechanisms have to be put in place before another reform can be launched. In this approach, one reform clears the way for another. This is most obviously the case in the financial sector, where it is essential to put in place deposit insurance and clean up bank balance sheets (clear away bad loans), before proceeding to interest rate liberalization. In turn, interest rate liberalization is a necessary precondition for broader capital account opening and financial market liberalization. The Reform Small Group has so far not publicly intervened in financial sector liberalization, apparently leaving that to the experienced technocrats inside the People's Bank of China system. However, it is well known that finance technocrats adhere strongly to a world-view in which sequencing is of fundamental importance: they are waiting for the final approval of deposit insurance before moving on to the next set of reform measures.

The Reform Small Group, at its previous (third) meeting on June 6, passed on a fiscal reform program which was subsequently approved by the Politburo. This fiscal reform program is frequently mentioned as one of the first complete, concrete achievements of the Third Plenum reform process. From what we know about the fiscal reform program, it clearly fits into the pattern of a highly structured and sequenced package of interacting measures, with clear priorities. Unfortunately, the full fiscal reform program has not been openly published, so it is impossible to evaluate fully the individual elements, but enough has been revealed to show the overall strategy and content. By far the most authoritative evidence we have of the fiscal reform is a detailed, but still quite brief, interview with Finance Minister Lou Jiwei.[8] Lou lays out a program of fiscal reform in three stages. The first stage, beginning immediately, is an essentially technocratic bundle of reforms of the "budgetary management system." Included in the "budgetary management system" are procedures for budget transparency, better legal foundation and oversight by the National People's Congress, and systems for managing local government debt.[9] There will be more consistent legal definition of, and accounting for, intergovernmental fiscal transfers and limits on local government tax concessions. Finally, a set of new measures will be adopted to set up local government balance sheets (showing both assets *and* liabilities) and new systems of accountability and performance evaluation will be introduced for government officials. This is already a broad and ambitious program, and this is only stage one! These are indeed hugely important measures, but note that the initial stage leaves the basic distribution of resources, responsibilities, and control among different levels of government fundamentally unchanged. All those politically sensitive distributional issues much discussed in the run-up to reform—particularly those governing the distribution of revenues between central and local government—have been deferred to 2016 or even beyond.

The second stage of Lou's fiscal reform program is to establish a complete new system of tax *types*, which includes applying value-added taxes universally to all services and creating nationwide property and natural resource taxes.[10] In the implicit timetable that Lou lays out, the second stage would be addressed beginning in 2015. Finally, in a third stage, expenditure responsibility between central and local governments will be adjusted, under the premise that the local government share of revenue collection will remain roughly constant. Only at this stage will the really tough political decisions be tackled: whether local governments will continue to have access to land revenues; whether they will retain responsibility for social security funds and other types of welfare; whether they will continue to control regulatory agency budgets; and whether they will run education. At that point, central government transfers to local governments will be adapted to accord with this new definition of responsibilities. This third stage is to be tackled in 2016, with the hope that a complete new fiscal system would be up and running by 2020.[11]

The fiscal reform program is certainly an ambitious one, and it relies on a rigorous internal logic. With respect to its prospects for implementation, it faces some very severe challenges. It defers some of the most controversial issues to a later stage, which ensures that the overall process keeps moving, and the information and technical capabilities of reformers are enhanced. However, this also means that it defers the solution of some of the most serious problems and therefore the reform "payoff." For example, can local governments be weaned from their reliance on land revenues, and face more balanced fiscal resources and incentives that reduce their manipulation of land markets? It looks like we will have to wait until 2017 to find out. If land markets crash in the meantime, how will that affect the fiscal reform? In the meantime, some of the benefits of reform will remain hostage to finding solutions to potentially difficult technical administrative problems. Moreover, since new budgetary systems clearly have to go through the National People's Congress in the form of multiple new budgetary laws and procedures, the potential for delays is substantial. The National People's Congress, especially its Finance and Economics Committee, is packed full of retired bureaucrats with a deep understanding of issues, strong opinions, and a knack for finding controversial areas for knock-down, drag-out arguments. It might take a long time for the entire program to work its way through the legislature.

The Reform Small Group must oversee all these different processes. So far, almost all the progress they have reported has come in areas where professional teams have been working for a while (even since before the Third Plenum). The two concrete achievements of the Reform Small Group so far have been passing the Fiscal Reform Program and the Urban Household Registration Reform. The Fiscal Reform we have just discussed; the Urban Household Registration Reform was not really a new reform at all, but rather the outcome of a program that had been ongoing at the National Development and Reform Commission (NDRC) for more than two years. In this case, the reform output reflects that lineage. While the reform makes some progress, it is overall a rather timid document. It creates a "path to citizenship" for some 100 million rural-to-urban migrants over the next seven years, by spreading a "points system" that gradually qualifies migrants for full urban residence status. However, it leaves in place a stark distinction between big cities (over 5 million), which will continue to have extensive restrictions in place, and it implies that some 200 million migrants will still be resident in cities without full urban residence status in 2020.[12]

Overall, then, we see the Reform Small Group juggling problems of immense complexity, and struggling with strategies that must vary enormously among different issue areas. It is a mistake to see the whole thing as a single process that can have a single "strategy." Still, for different reasons in different areas, the concrete results that people can point to today are rather meager. Significant changes in household registration, the fiscal system, or state enterprises have not yet emerged from the end of the pipeline, although the reasons for slow progress are quite different in each issue area. Perhaps for this reason, though, the Reform Small Group passed on a few areas at its recent meeting that are less crucial to the overall reform project, but which have attracted a certain amount of popular attention. A sprinkle of populism, perhaps, designed to give the impression that the reform agenda is moving forward, to link it with the anti-corruption campaign, and to generate news coverage during the quiet days of August.

Central Enterprise Manager Compensation

The headline issue that the Reform Small Group addressed was managerial compensation in central government state-owned enterprises (SOEs). The Reform Small Group discussed two related documents, one on salaries and the other on managerial expense accounts. In fact, these are issues that have been around for a long time, debated for years, and the subject of previous official documents that have been ineffective.[13] By taking up the matter at a top party group, the Reform Small Group clearly hopes to generate sufficient political momentum to finally resolve the issue. The fundamental problem is that central SOE managers are also, to a certain extent, bureaucrats: they have a bureaucratic "rank," and they often operate firms in noncompetitive markets with a public service component. However, their salaries are strongly influenced by salaries of executives in large, competitive firms (state and private), and can thus be much higher than those of bureaucrats at the same level. The problem is not actually so great in the big firms controlled by SASAC (the State Asset Supervision and Administration Commission), because executives there have their salaries set by the SASAC compensation committee, which has a reasonably transparent set of procedures and does in fact sometimes penalize managers severely for under-performance.[14] However, the Reform Small Group's intervention is likely to be controversial and consequential for two reasons. First, it includes *all* central enterprises, not just those under SASAC, so the heads of the state banks and other financial sector executives would be included, as well as managers in the lucrative railway sector, and so forth. Second, along with the regulations on wages, the Reform Small Group also discussed a regulation on perks and benefits, strongly condemning the policy of automatically assigning generous expense accounts to top managers. These two issues are potentially explosive.

Wage differentials are widely recognized as a problem. According to CASS scholar Liu Xiangli 刘湘丽, the average annual wage in the 113 central [SASAC] enterprises and their stock-market-listed subsidiaries was 111,000 RMB, compared to 47,000 RMB for all urban "non-private" entities, and only 29,000 for employees of urban private firms. (The higher wage for central firms is the outcome of multiple factors: central firms enjoy market protection and share above-market incomes with their workers; but those workers are also substantially more highly educated and experienced than the average urban worker.) According to a 2011 survey by SASAC, the average of top-level managers at those central firms was 720,000 RMB, or 6.5 times the salary of the average worker in those firms; 15.3 times the average public sector worker, and 25 times the average private sector worker.[15] Whether or not these differentials are a problem can be debated; but the private sector worker who sees an SOE manager earn 25 times what he earns, plus receive lavish benefits and perks, might be forgiven for feeling some resentment. Income issues will shape the entire SOE reform process.

The Reform Small Group discussed the issues but did not approve either final document. It was therefore quite surprising that just 11 days later, on August 29, the full Politburo met and approved both documents, presumably after revisions. Managers of state banks and other state-run financial institutions cannot be happy: perhaps the fast action was designed to preempt a lobbying campaign. In any case, this decision follows the pattern evident since the beginning of the Xi administration, in which core supporters of the government—in this case, managers of central state firms—are called upon to make significant sacrifices. In the final section, we will discuss the potential significance of this measure.

Where Is the Action Taking Place?

While the Reform Small Group discusses managerial compensation, most of the action with respect to SOE reform is taking place elsewhere. Central SASAC finally released its long-delayed program for SOE reform on July 15, and it was (predictably) underwhelming. SASAC selected six firms to pilot three reforms. Two firms were picked to pilot conversion into State Capital Investment Firms: the existing State Development and Investment Corporation (SDIC: 国家开发投资公司) and the grain and agriculture processing and trading giant COFCO (中粮集团有限公司). Two firms are to pilot diversified ownership trials: Xinxing Cathay International (新兴际华集团) and the China Energy Conservation and Environmental Protection Group (CECEP: 中国节能环保公). Two firms are to pilot a program of expanded powers for the board of directors, under which the board will have full power to select managers and set their compensation: China National Building Materials Group Corporation (中国建筑材料集团) and Sinopharm (中国医药集团总公司). Later, two or three more firms will be selected to pilot a program of stationing inspectors at firms. Each group of pilot firms is to be watched over by a specialized reform group; there are no timetables or deadlines; and "as reforms are mature, they will be approved and implemented by the main SASAC reform group."[16]

Central SASAC's pilots are excessively cautious. The idea of tailoring each reform to one or two specific firms is problematic to begin with. Moreover, one of those firms, CDIC, is essentially an offshoot of the old Planning Commission, and is a firm SASAC has long sought to build into a more powerful investment entity. It is hardly conceivable that anything useful can come from that particular experiment. Expanded power to the board of directors is, of course, an essential and sensitive reform, since it requires the Communist Party to irrevocably delegate to the board of directors the power to control managerial personnel. (The party would, of course, continue to appoint the directors themselves). SASAC is not so much trying to push forward reform as to demonstrate compliance, not be left out, and protect their existing position.

Much more activity is occurring at the local level. Shanghai was able to report positive results for the first half with its local version of SOE reform.[17] Shanghai's program, like many of the other local initiatives, deserves detailed study and analysis. A quick reconnaissance reveals that the basic approach consists of four main elements: first separating enterprises in types depending upon their market status (competitive, monopoly, or public service); completing the conversion of firms into fully corporatized and preferably listed firms; selling ownership stakes in those firms; and creating "investment platforms" that will manage public (Shanghai) wealth at an arm's length and in a transparent way. Shanghai's position is rather special, not only because it is Shanghai, but also because although it has a relatively large portfolio of government firms, profitability is dominated by two large unusual firms: Shanghai Automotive Industry Corporation (SAIC) which has huge joint ventures with both General Motors and Volkswagen; and the Pudong Development Bank, which increasingly serves as the financing arm of "Shanghai Incorporated." It is not completely clear that arrangements that work in Shanghai will work in the rest of China.

However, many other localities are pursuing SOE reform. Guangdong, for example, just released new regulations on SOE reform that were more specific and aggressive than many expected, calling for the conversion of 70 percent of their firms to "mixed ownership" and the concentration of government ownership in 30 large-scale utilities and public service firms.[18] All these initiatives deserve further study. There is no doubt that some initiatives should be viewed skeptically: Many local governments have made terrible investments and would love nothing more than to attract private investors into a "mixed ownership" vehicle, to reduce their own exposure and risk. Such arrangements offer nothing real to private investors, and could increase financial risks down the road. But some attempts also seem to be promising efforts to restructure the state sector and, after many years, launch it onto a more thoroughly market basis. At this point, the real action is at the local level, in the Ministry of Finance, and in the financial bureaucracies. For the Reform Small Group, the challenge is to foster, encourage, and select among this diverse range of activities.

Conclusion

While the Reform Small Group stayed busy in the summer, concrete achievements were modest. The strains of the extraordinarily broad reform agenda are clearly beginning to show in the implementation process. Many of the items discussed by the Reform Small Group have in fact been gestating in the bureaucracy for a long time, in some cases well before the Third Plenum last year. That is true of the SOE manager compensation program and also of college entrance reforms, which are related to a large-scale program that the Ministry of Education had completed and tabled in January 2014.[19] The other item—integration of old and new media into new national champions—is an important initiative that is not, however, discussed here because it has nothing to do with economic reform.

The sudden rapid movement on central SOE manager compensation was an unexpected action that is subject to different interpretations. In the first place, it is unclear whether a broad document on compensation in many different kinds of central SOEs can be intelligently crafted, and whether such formulas can be made to work (the actual decision has not been publicly released). Moreover, it is unclear whether such a system, if it were successfully put in place, would constitute a "reform": since it puts less flexible quantitative ceilings in place on managerial compensation, in some respects it represents a movement away from market-oriented reform. Finally, there is the suspicion that this move was simply a way of pandering to a public increasingly annoyed by the privileges possessed by central SOE managers. However, these judgments are probably being made within too narrow a context.

Policies of the Reform Small Group have a large impact because they help shape the broader process of experimentation and change now occurring predominantly at the local level. Discussions of managerial compensation make it clear that the current round of SOE reform is not designed to give free rein to existing SOE managers. This marks a sharp contrast with the important SOE reforms carried out under Zhu Rongji from 1996 to 2002, when managerial buyouts (MBOs) and insider-driven conversions were common. SOE reform is unfolding in a very different environment than was the case in the 1990s. The Anti-Corruption Campaign has a huge effect: reformers must be careful not to cross lines, even though those lines have not been clearly demarcated. The center has made clear that SOEs must contribute more dividends to the public treasury, and that this is a required component of local SOE reforms. Income distribution is a major issue that will shape how SOE reforms unfold.[20]

The decisions on managerial compensation send a clear signal that SOEs have to be converted into marketized corporations *first*, and authority given to the board of directors, before managers can expect to reap financial gains. An important step in the current wave of SOE reforms has been the drive to classify existing SOEs into those with purely market functions and those with social service responsibilities. Those with purely market functions, operating in a competitive environment, should be able to go ahead and pay managers market-based salaries. SOEs with social service responsibilities can remain under the protective government umbrella and implement less thorough-going reforms, but their managers must now forego the high salaries that can come from a market-based managerial system.[21] At a stroke, this changes the incentives of the managers of existing big central SOEs. Previously, such managers might have been expected to resist classification as a competitive market-based firm, since this would simply make their lives more difficult; but now they have an incentive to support such classification because that is the only way they can earn high salaries. In short, the new managerial compensation rules restrict the operation of the market inside the state sector, but they may also give insiders stronger incentives to push firms out of the state sector and into the marketplace.

Notes

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[21] "Compensation in Central Enterprises.." (See note 3).