Supply-Side Structural Reform at Mid-year: Compliance, Initiative, and Unintended Consequences

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Implementation of supply-side reforms has now passed to provincial governments. While provincial leaders are careful to display compliance with the center’s goals, they also shape the program to meet their own needs. The resulting behavior is affecting political and economic outcomes in ways that are frequently unanticipated.

This year in China, it is impossible to avoid “supply-side structural reform.” Floated in the fall of 2015, and formally adopted in December, it has been pushed energetically since the beginning of 2016. After a series of high-profile articles in May 2016, the emphasis on supply-side structural reform (SSSR) has increased further, and it has become virtually the only high-profile economic policy in China. But what is it? In this short piece, I go beyond the definition of SSSR to give a sense of how it fits into the broader economic and political context.

The basic content of SSSR was described in CLM 491 in early March, and the policy has been consistently promulgated ever since. SSSR begins with an emphasis on reducing excess capacity in heavy industries such as steel and coal, and overall includes five main policy initiatives:

1. Cut excess [industrial] capacity
2. Cut down excess stocks [of unsold housing]
3. Cut leverage (i.e., reduce debt)
4. Reduce costs
5. Fill in weak spots

These five policies together make up an exceptionally broad and, as we shall see, elastic set of policy tools. In this issue of the Monitor, I examine the way that the function and impact of SSSR has changed as the main responsibility for implementation has shifted from the central government to the provinces.

From Center to Province

Supply-side reform is very much a top-down initiative, emerging from the party system, and in particular from the two Leadership Small Groups (LSGs) chaired by Xi Jinping.2 Party groups in the provinces have their own versions of the “Deepening Reform LSG,” invariably headed by the first party secretary of the province. The provincial party secretary, therefore, cannot avoid taking a personal interest in SSSR and must oversee its progress in his province. However, the actual implementation is done by provincial governments, which have the staff and experience to carry through economics-related policies.
The underlying logic of SSSR is strong and simple. As China’s economy slows, investment decisions made in the past turn out to be wrong. In particular, investment was made in coal, steel, cement, and other heavy industrial commodities that from today’s perspective are not needed. Policy-makers believe that China will be like other, earlier developing economies which at a certain point reached “peak steel” and “peak coal” and saw their aggregate production stop growing. For example, China’s crude steel production surpassed 800 million metric tons (MMT) in 2013—far more than any other country has ever produced—and it is unlikely that China will ever produce much more than that. But investments continued to be made before and after 2013, and capacity is now estimated at 1,200 MMT, 50 percent above output: a shakeout is necessary. Central policy-makers fear that the restructuring is proceeding slowly, and that precious resources—land, labor, and capital—are tied up in idle capacity. Moreover, they strongly suspect local governments of slowing down restructuring in order to protect their local industries, so that they can keep workers employed and use local firms to make claims on finance from the banking system. Central government officials reason that by providing money and political cover to local officials to allow them to take care of redundant workers, they can accelerate restructuring and minimize political opposition.

As part of SSSR, policy-makers have demanded closure of 45 MMT of crude steel capacity and 250 MMT of coal capacity in 2016, and a total of 150 MMT and 1,000 MMT respectively during the 13th Five-Year Plan period (through 2020). The logic is similar for other commodities and for housing stock, and dealing with the debt assumed to make these investments is the third point of SSSR. In pursuit of these objectives, the center has issued targets to individual provinces, and the provinces have signed “target responsibility documents” for capacity reduction. The center is sensitive to public opinion about worker interests, and has repeatedly said that there will not be mass layoffs as in the late 1990s, that workers will be taken care of, but that employment in affected sectors will be reduced by a large amount in an orderly fashion. In pursuit of this objective, the center has kicked in 100 billion yuan to be used for labor resettlement and training, and the localities are expected to kick in an additional 100 billion. The overall process is now in local hands: at least 20 provinces have publicized their initial targets and plans. Typically, these targets include capacity reductions and sometimes capacity ceilings for a range of commodities, as well as plans for dealing with “zombie firms” (僵尸企业). Zombie firms (the term comes from Japan) are long-term loss-makers and firms that may have already ceased production but still have unpaid debts or other obligations.

In addition to this core obligation to close down industrial capacity, SSSR provides provinces with lots of scope for additional actions and creativity. The second item, “reducing stocks of unsold housing,” may mean creating new markets for affordable housing, which often entails new rental systems and bringing rural-to-urban migrants into the urban housing market. Lowering costs opens the door for a range of tax reductions and lower-cost provision of public services. Filling in weak spots can mean virtually anything that a creative local official wants it to mean. Although SSSR means burdensome obligations for local officials, it also gives them new avenues to be creative, to make plans, intervene in the economy, and deploy resources.
Displaying Compliance and Initiative

For provincial leaders, this is a sensitive time. Key personnel decisions are being made right now that will shape the new leadership group set to emerge at the 19th Party Congress, in October–November 2018. A few lucky provincial leaders will be promoted to the Politburo, and one or two might even make it into the Politburo Standing Committee. More broadly, most provincial leaders face some kind of imminent career change, and even some leaders with no chances of promotion might hope to avoid the wrath of higher-ups and end their careers on a successful and secure note.

Provincial leaders thus have a particularly strong incentive now to demonstrate their unflagging compliance with central directives, and also their own creativity and competence. It is known that Xi Jinping likes capable managers, and views the ability to take the initiative as a key (desirable) feature of Communist Party leaders. (Of course, Xi’s favor is contingent on them also displaying policy compliance and personal loyalty). Given that SSSR has repeatedly been declared the main economic policy of 2016, this is the ultimate opportunity to display compliance and initiative in general.

Based on these considerations, our attention is naturally drawn to four provinces and their leaders. The party secretaries of Guangdong and Chongqing are candidates for membership in the Standing Committee in 2017. This means they have a particularly strong incentive to demonstrate loyalty and show exceptional performance, because doing so will smooth their way to the pinnacle of power. Hu Chunhua, in Guangdong, has always been a high flyer. He graduated from Beijing University in 1983 with a degree in Chinese literature, and served as head of the China Youth League (2006–08), and then became the youngest governor in China, of Hebei Province. Sun Zhengcai became minister of agriculture in 2006, and his stature was confirmed when he was appointed party secretary in the sensitive Chongqing post (following Zhang Dejiang). Whether they can maintain the consistent patronage from top leaders that they enjoyed early in their careers could easily be determined by their performance in SSSR.

At a slightly lower level, two provincial governors are interesting. Lu Hao (陸昊), the governor of Heilongjiang, has had a career that echoes that of Hu Chunhua to a remarkable extent. Lu Hao succeeded Hu Chunhua as head of the China Youth League (2008–13), and then also went on to become the youngest governor in China, in Heilongjiang. Lu Hao’s career is already thoroughly intertwined with SSSR because of a rather disastrous effort he made to suggest that his handling of Longmei Coal Mine was a model of care for workers’ interests during restructuring. Lu Hao’s claim that pay was up to date for all underground coal miners spectacularly backfired during the National People’s Congress meetings in March when thousands of Longmei miners took to the streets protesting because they hadn’t been paid in months. Lu Hao was forced to issue a retraction. The current governor of Shandong is Guo Shuqing, an official with rich experience in central government financial institutions, including as chair of the China Securities Regulatory Commission (2011–13). Guo, who turns 60 in August, is considered to be in the running to be the next central bank governor, when Zhou Xiaochuan retires. His performance in Shandong will be crucial if he is to take over the highly coveted central bank job.
For each of these ambitious leaders, the SSSR is both a challenge and an opportunity. They must demonstrate compliance, to show that they are loyal to Xi Jinping and willing to be active agents of his policies. At the same time, they must demonstrate initiative, showing that they can be creative and are capable of assuming top leadership posts. Compliance comes primarily in fitting in with the program and reducing excess industrial capacity; initiative, on the other hand, is best displayed in reducing the stock of unsold housing, lowering costs, and filling in the weak spots. We examine these aspects of SSSR policies in turn.

**Compliance: The Example of Steel**

Of course, virtually every province begins by initially signaling compliance. Provinces will accept targets “suggested” to them by the center, and project even larger reductions, to show their enthusiasm. Provinces have already projected well over 200 MMT of capacity reduction for crude steel, compared to the 150 MMT suggested by the center. But of course, provinces will be more cautious about actually committing to targets, and will seek to push back the deadlines for actual capacity closures, and maneuver to protect their favored firms. For example, Hebei, by far the largest steel producer, “projects” a reduction in capacity of 100 MMT by 2020, but has agreed to a target of 49 MMT by 2020, and 14 MMT in 2016. As of the end of July, Hebei had only attained a third of its 2016 target. What the center demands from provinces can vary substantially according to conditions. (We do not have access to the original targets for capacity closure, but we can make surmises based on announced targets.) Provinces with better economic prospects, and access to more sources of funding, are asked to make a bigger effort in closing heavy industrial capacity. Provinces with bigger problems are allowed to make a lesser effort. In particular, the northeastern provinces of Heilongjiang, Jilin, and Liaoning face especially difficult problems. In addition, five provinces produce well over half of China’s crude steel (see table 1). Clearly, what happens in those five provinces will determine the fate of SSSR’s steel program. The central government seeks to close capacity equal to somewhere between 15 and 19 percent of the 2015 output of 804 MMT; clearly Hebei and Shandong are doing much of the heavy lifting. Jiangsu’s contribution is just average. Whereas the steel industry in both Hebei and Shandong is dominated by large SOEs, that of Jiangsu is predominately private, which introduces some more complications. Of course, Hebei cannot escape close scrutiny: not only does it produce an enormous amount of steel, it also stands to receive hundreds of billions of RMB in central government investment as part of the restructuring of the Beijing-Tianjin-Hebei region. Hebei must play its cards carefully in order to benefit from the top-down restructuring of a giant megalopolis.

What actually happens as provinces try to close down capacity? Based on interviews, the most common procedure starts with provincial leaders calling in the most important stake-holders. Crucially this includes the three or five largest producers; in this case, the largest steel companies. These producers are essentially informed that they will temporarily function as a cartel. They will have to make sacrifices, closing down some
of their most inefficient and underutilized capacity, while simultaneously taking over small-scale and technologically backward competitors and responsibility for their debts and burdens. However, they will get benefits: financial support will be forthcoming to relocate and retrain workers, and they get some benefits from a tighter oligopoly with reduced competition. Provincial leaders also declare their intention to push smaller, backward firms harder by strictly enforcing safety, environmental, and technology regulations; this passes for market-conforming methods of reducing capacity.

**Table 1**

*Top Crude Steel Producers and Their Capacity Closure Targets (in millions of tons)*

<table>
<thead>
<tr>
<th>Name</th>
<th>2015 output</th>
<th>2020 closure target</th>
<th>2020 closure/2015 output</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hebei</td>
<td>188</td>
<td>(14 in 2016; 31 in 2017)</td>
<td>26%</td>
</tr>
<tr>
<td>Jiangsu</td>
<td>110</td>
<td>17.5</td>
<td>16%</td>
</tr>
<tr>
<td>Shandong</td>
<td>66</td>
<td>(2.7 in 2016; 10.65 through 2018)</td>
<td>23%</td>
</tr>
<tr>
<td>Liaoning</td>
<td>61</td>
<td>6 in 2016, according to an old plan; no additional commitment</td>
<td>c. 10%</td>
</tr>
<tr>
<td>Shanxi</td>
<td>38</td>
<td>net zero</td>
<td>0</td>
</tr>
<tr>
<td>Central Government SOEs</td>
<td>7.2 in 2016</td>
<td></td>
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**Initiative: Building Provincial Objectives into Supply-Side Reforms**

A successful provincial response to SSSR involves going well beyond the capacity-reduction measures. Workers displaced by declining heavy industries need someplace to go: not all laid-off workers can drive for Didi Chuxing (China’s Uber). In fact, there is considerable leeway for each province to build its own specific objectives into the structure of its local SSSR plan. Each of the provinces has taken a slightly different approach to SSSR in its locality.

The leader is almost certainly Guangdong, which produced a six-part, 42-page document consisting of an overall vision statement plus five sub-documents, one for each of the five points of SSSR. Moreover, Guangdong got there early, ratifying its document on February 28. To be sure, Guangdong has it easier than other provinces in two respects: its export-oriented production structure is much less tied to heavy industries than that of some northern provinces, and it has been actively engaged in restructuring in the face of rising labor costs for the last five years. With less obvious excess capacity, Guangdong can concentrate on a program to close and restructure zombie firms. There is a substantial stress on accelerating construction of municipal infrastructure and developing emerging industries such as electric vehicles. While these are staples of many provinces’ plans, Guangdong’s plans are more clear, better developed, and more likely to succeed. Guangdong has placed a relatively large stress on Item 4, “reduce costs.” It has set a
target of reducing firm costs by 400 billion RMB by the end of 2016: over 5 percent of provincial GDP, a substantial number. More than half of this would come from reduced taxes; further reductions would be achieved through partial elimination of administrative fees and by decreasing contributions to various social security and welfare funds. Guangdong’s plan provided a list of 86 administrative fees to be terminated in pursuit of a “zero administrative fees on business” policy. In other words, Guangdong has taken advantage of SSSR to produce a credible vision statement, and has moved quickly to integrate SSSR with its ongoing developmental programs. In related fashion, the partially independent municipality of Shenzhen is introducing some innovative programs to give migrants the opportunity to “rent to buy,” in an attempt to make Shenzhen’s notoriously expensive housing more accessible.10

Shandong has also been a leader in actively exploiting the opportunities in SSSR.11 Like Guangdong, Shandong was an early mover, rolling out a capacity-reduction program promptly. Moreover, as befits Guo Shuqing’s background in finance, the province has been proactive in developing direct finance mechanisms to replace debt in struggling enterprises. This goes beyond the “debt-for-equity” swaps that have been tried out in many locales. Shandong is experimenting with local stock market listings for numerous small firms, providing subsidies for firms listing locally, and setting up creditors’ committees for troubled indebted enterprises. Shandong also stresses lowering costs and cutting social security contributions and taxes. Shandong explicitly proposes expanding medical care outlays as part of the solution to keep employment growing. Like Guangdong, Shandong put forward a “zero administrative fees on business” policy (though with less supporting detail). Shandong’s plan, like Guangdong’s, is a reasonable mix of regulation and concrete policy, informed by a developmental vision.

Chongqing’s approach is far more difficult to ascertain. Municipal documents are either general and abstract, or surprisingly legalistic.12 The official municipal documents posted online make much mention of procedures to be followed, but contain few concrete steps or targets. Admittedly, this could be a good sign, indicating a government that is stepping back and letting the market decide, but it seems more likely that Chongqing is simply trying to maintain room for maneuver with SSSR. Adding to the mystery, there were widespread reports that long-serving Chongqing mayor Huang Qifan reported on Chongqing’s experience to the Finance and Economics Leadership Small Group in May. His (reportedly) long speech there was posted online, but has since been scrubbed from the web.13 Chongqing politicians are clearly trying to derive advantage from SSSR, but exactly what their strategy is cannot be determined from the evidence at hand.

A number of other provinces are attempting to absorb SSSR into existing development programs in a fairly straightforward way. However, different provinces act with very different intent. Gansu has portaged into its SSSR program existing plans to consolidate state enterprises, build three globalized SOE champions, and pour money into high-tech industry.14 Shanghai, in a bold move, explicitly declares that “openness is Shanghai’s greatest comparative advantage” and re-commits to its new (but struggling) Free Trade Zone in its SSSR program.15 Shanghai also pushes its program for sophisticated services
and research and development, a variant of national priorities, to be sure, but a reasonably well-thought-out and realistic variant.

Heilongjiang has one of the most interesting programs, with perhaps the most surprising emphasis. The province’s economic problems are severe, including a slowing economy, proportionally large excess capacity, and population outflows (which accelerates population aging). Its SSSR program acknowledges these problems and pushes drastic measures: the capacity-reduction claimed and promised is more than the 4.2 MMT actually produced in 2015. But at the same time, according to a semi-official explication of the policy, “because of the extensive negative publicity associated with the Longmei unpaid back wages, Heilongjiang must be especially careful to ensure that redundant workers are taken care of, and enrolled in retraining and welfare programs on a priority basis.” Perhaps most surprising are the four priority sectors designated for expansion: green agriculture, tourism, old age care, and health services. Provincial planners reason that millions of people go to Hainan in the winter to escape the cold, so why not have millions come to Heilongjiang in summer to escape the heat? Also, given that Heilongjiang has a very high proportion of retired state workers with strong pension benefits, it certainly makes sense to prioritize the delivery of services to these people as an important function of government. However, are these enough to constitute a growth strategy for a province traditionally specialized in resources and large-scale agriculture? It will be interesting to watch.

Unanticipated Consequences

Assuming SSSR continues to be a top priority of central leaders through the end of 2017 at least, we can already see three emerging consequences that were not at all part of the anticipated course of the program. SSSR is leading to regionally differentiated programs, encouraging interventionist government programs, and having an important impact on political competition for the next generation of leadership.

First, SSSR is clearly a top-down program, designed to push localities to do things they would generally prefer not to do. However, in implementation, it has become highly diversified across regions. This is due in part to the wide regional variation in underlying economic conditions. Aging, obsolete industrial capacity is a huge problem in the northeast and north (including Shanxi and Inner Mongolia), but substantially smaller in the south and east. All provinces have to demonstrate compliance with SSSR, but many of them do not have significant excess-capacity problems, and thus have simply adapted SSSR into something quite different, most often streaming its provisions into their pre-existing development strategies. In very different ways, one could say that Guangdong, Shanghai, and Gansu are all doing this. When excess heavy industrial capacity is not a problem, provincial leaders target “zombie firms” instead, since these can potentially be in any sector. As time goes by, the difference in these programs will likely be associated with increasingly large differentials in provincial economic performance, which are already significant.

Second, SSSR is designed to accelerate structural changes that are driven by market changes; moreover, its designers advocate using market mechanisms as much as possible.
Yet SSSR in its essence is nonetheless a program of intensified government intervention. It requires government to set up what are essentially cartels of firms; it encourages governments to distribute subsidies, tax breaks, and subsidized loans to firms undergoing difficulties; and it asks governments to “fill in weak spots” in a way that can justify ambitious new government programs. SSSR designers acknowledge this danger and urge local governments to act according to market principles, by which they mean using objective regulatory standards to drive bankruptcies and determine the targets of acquisitions. These exhortation are clearly a form of damage limitation; overall, SSSR is likely to result in more interventionism by local governments, not less. This is especially true when we factor in the political incentives which drive local government leaders to appear proactive and forward looking, even as they demonstrate compliance.

Finally, political incentives built in to SSSR implementation will likely determine some important outcomes. On early evidence, it looks like Hu Chunhua in Guangdong and Guo Shuqing in Shandong will benefit from their effective adaptation of SSSR, having added to their stocks of political capital. Lu Hao seems to be in the position of throwing a “hail Mary” pass: already squeezed out of a once highly favorable position in the broad succession process, he is now scrambling to stay relevant. We cannot read between the lines of the Chongqing situation: Party Secretary Sun Zhengcai has kept a very low profile, while Mayor Huang Qifan has been visible and arguably more than a little erratic. Neither is likely to gain much from the situation.

Conclusion and Observations

It is likely that SSSR will continue to be promoted by central officials and serve as a driving force of economic and political changes over the next few years. This presumption comes from the fact that Xi and his economic leadership have promoted SSSR to such a degree that they have essentially tied their own fate (and face) to the successful implementation of the program. The official line right now is that SSSR and reforms in general have faced unprecedented opposition that has stalled their implementation. Since mid-year, central officials have signaled dissatisfaction with the pace of capacity closure and stressed the need for greater discipline. Indeed, the conclusion that capacity reduction is behind schedule is already finding its way into well-informed accounts, such as a recent report in the London Financial Times. In fact, it makes more sense to see these central government statements as a signal of central government determination, rather than an objective measure of the degree of implementation to date. The center is taking this opportunity to re-emphasize its own seriousness, and to make sure that the provinces treat their year-end targets with respect. The center is declaring to the provinces that changing economic conditions will not lead them to slacken the implementation pressure.

Realistically, it is unreasonable to declare that capacity reduction is behind schedule only a few months after provinces have received their assignments. Moreover, the center wants provinces to move carefully in the sensitive area of worker redundancies. In fact, the pressure for implementation of SSSR is a critical part of Xi’s strategy to mold the Chinese political system into something “more disciplined,” that is, into something that
expresses Xi’s will more effectively. Consider this statement about implementation of SSSR before year-end:

“The target responsibility documents signed by every province are ‘military orders,’ and at the end of the year there we will check inventory and render detailed accounts.” On July 14, 2016, the spokesman for the National Reform and Development Commission Zhao Chenxin said that this year’s targets for reducing capacity in steel and coal had to be met, and that there would be strict accountability for anyone not meeting the full year target.19

More broadly, on July 22, 2016, at the 26th meeting of the Deepening Reform Leadership Small Group, Xi Jinping once again called for tighter supervision and closer accountability in the reform implementation process. For the first time, he advocated “three supervisions, three inspections” (三督三察) to improve implementation. Details of this proposal have not yet been released, but it is certainly consistent with Xi’s continuous emphasis on discipline and top-down leadership. In other words, Xi is attempting to introduce new procedures of monitoring and verification. What is clear is that Xi Jinping has now lined up all his forces behind the implementation of supply-side structural reforms. SSSR is an instrument, not just for the restructuring of the economy, but for the remolding of the political system into something more disciplined and with power concentrated at the top and wielded effectively down through the hierarchy.

Whether he can achieve his objectives, and whether those objectives prove robust in the face of unanticipated consequences, will only gradually become apparent over the next year or two.

Notes
2 These are the “Deepening Comprehensive Reform Leadership Small Group” and the “Finance and Economics Leadership Small Group.” See CLM 49.
Five province-level leaders are members of the Politburo: Han Zheng in Shanghai, Hu Chunhua in Guangdong, Sun Zhengcai in Chongqing, Zhang Chunxian in Xinjiang, and Guo Jinlong in Beijing. According to Miller, Hu in Guangdong and Sun in Chongqing might reasonably hope to make it to the Standing Committee. Both were born in 1963 and so are members of the “Gen 6.0” cohort, but on the other hand past selections of successors have often come from outside the ranks of the Politburo. See Alice Miller, “Projecting the Next Politburo Standing Committee,” China Leadership Monitor, no. 49 (Winter 2016).

“Lu Hao’s effort to deceive Xi Jinping became the biggest scandal at this year’s ‘Two Meetings’” (陆昊瞒骗习近平 成本届“两会”最大丑闻), World Daily (世界日报, New York), March 14, 2016, accessed at http://www.wenxuecity.com/news/2016/03/14/505561.html.

“The plan for cutting steel capacity in every region nationwide has emerged!” (see endnote 4).

Table 1 adapted from MySteel, “The plan for cutting steel capacity in every region nationwide has emerged!,” 2015 Output from National Bureau of Statistics, China Statistical Abstract 2016, p. 134.


Duowei News (多维新闻), “Huang Qifan’s bold and elegant speech circulates widely; Now it’s already been deleted” (黄奇帆万字雄文曝光疯传 目前已被删), July 25, 2016, accessed at http://china.dwnews.com/news/2016-07-25/59756070.html. The controversial and capable Mayor Huang Qifan, turning 65 next year and tainted by his association with Bo Xilai, has often been the subject of rumors suggesting he will move
to the central government, most recently as supposed secretary-general of the State Council. But so far none of those rumors have proven to be true.


19 Wang, “As capacity reduction targets arrive the countdown starts” (see endnote 3).