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Commission**

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Hearing on: China Ahead of the 13th Five-Year Plan:
Competitiveness and Market Reform

Panel III: The Broader Implications of China's Five Year Plans

David Frey, Partner and Head of U.S.-China Strategic Corridor, KPMG in China

Summary:

- China's five-year planning cycles have been a fixture of economic policy development in China since the early 1950s. The Five Year Plans (5YPs)¹ have been important, recognized tools in setting national economic and social direction since that time. As such, 5YPs will almost certainly remain important planning mechanisms for the foreseeable future.
- The five-year planning process cascades from the central government outward regionally to provinces and cities, as well as through the ministries and state-owned enterprise (SOE) management.
- It is most appropriate to think of "the Five Year Plans" as a process rather than as a set of reports. The development of the main Five Year Plan by the central government in China is accompanied by the development of a whole series of related reports that are specific to sectors, regions, and themes of particular importance.²
- The process is sufficiently ingrained in Chinese government ministries and agencies at all levels – as well as in SOEs at central, provincial and local levels – for the process to stake a claim as the core strategic planning development tool for economic, industrial and social policy implementation.
- 5YPs seek to comprehensively integrate policies established through other government planning and public announcement processes, such as Party Plenums, and the annual *Government Work Report*. The five-year planning process serves as a mechanism for translating policy direction into practical guidelines, objectives, and targets.
- Although the private sector now accounts for a significantly greater share of total economic activity³ – a trend we expect to continue – private sector activity will be encouraged in directions favored by the government and discouraged in areas not favored by the government. As such, private sector expansion will unfold in large measure in areas consistent with 5YP guidance.
- We expect the 13th Five Year Plan – currently under drafting – to be highly consistent with the broad economic goals made public by President Xi Jinping and Premier Li Keqiang in major announcements.⁴ Based on reports issued by the China government to date, we expect the broad government goals of enhancing rule of law, transforming the economy to higher value-added manufacturing, increasing services sector components of the economy, boosting innovation within key industries, continuing the expansion of consumption, improving environmental protections, stimulating regional development in priority areas (e.g. "One Belt One Road"), supporting strategic emerging industries, and streamlining administrative procedures will be reflected as key themes of the 5YPs issued by government ministries, agencies, and SOEs.
- American companies continue to have an opportunity to leverage the five-year planning process to their advantage, and would be significantly disadvantaged to ignore it. Understanding China's economic development priorities and how they are translated into action at regional/local and sector levels, is critical to creating and maintaining a strategic value proposition to manage successful operations in China.
- The rapidity and complexity of China's ongoing economic transformation highlights China's sustained need for American innovation, technical achievement, and know-how. However, if government bodies in China are not made aware of a company's potential contribution to national and/or local development goals, the process of establishing and expanding a business profitably in China is made significantly more challenging.
- Government-to-government initiatives, exchanges and agreements can assist significantly in enhancing the positioning of American companies in this respect. The trade delegation of leading American greentech companies that recently visited China under the guidance of the U.S. Departments of Energy and Commerce – triggered by the climate change agreement signed by Presidents Obama and Xi in 2014 – is a recent and prominent example.

¹ The official name of the 12th Five Year Plan is: "12th Five-Year Plan for National Economic and Social Development of the People's Republic of China"

² For example, the "12th Five Year Plan 2011-2015" was released in draft in October 2010 for comment, followed shortly by the "12th Five-Year Plan for the Large-Scale Development of the Western Regions".

³ *Xinhua*, China's Private sector now accounts for more than 60 percent of GDP contribution, http://www.china.org.cn/china/Off_the_Wire/2014-06/12/content_32649060.htm

⁴ *Brookings*, Xi Jinping's Ambitious Agenda for Economic Reform in China, <http://www.brookings.edu/research/opinions/2013/11/17-xi-jinping-economic-agenda-kroeber> and *Xinhua*: Full Text Report on the Work of the Government, http://news.xinhuanet.com/english/china/2015-03/16/c_134071473.htm

Background

China's practice of setting economic and social policy in five-year increments was initially borrowed from the Soviet central planning model, but has since been adapted as an effective way by which the Central Government can disseminate policy agendas and priorities. Development of the 5YPs is an extensive and lengthy process administered by the National Development and Reform Commission (NDRC) over a nearly year-long period and involves many avenues of input and contribution from a broad array of government bureaus, provinces, cities, and enterprises, as well as commentary that is invited from foreign institutions such as the OECD and the World Bank.

The 13th Five-Year Plan (2016-2020) (5YP) will be released in March of 2016 in an atmosphere of slowing economic growth⁵ and shifting social and commercial priorities.⁶ It will articulate how the government plans to achieve the challenging balancing act of transitioning the drivers of economic growth in the country from export-oriented manufacturing and infrastructure investment to higher-value manufacturing, domestic consumption, and services. Subordinate plans at the local and State-Owned Enterprise (SOE) level will translate these broad concepts and policy guidelines into regional implementation plans.

1. Relevance of the 5YPs China today

China's five-year planning process has served the country well over the course of the last three decades of impressive economic transformation. During this period, the SOE share of total employment has fallen from greater than 60 percent in 1992 to now less than 15 percent according to World Bank estimates.⁷ Given this tremendous increase in the role of the private sector in China, one might be tempted to ask whether the 5YP is still an important policy tool in China. Despite the increase in the role of the private sector in generating economic activity, the role of the government remains predominate in China in setting objectives for the future direction of economic and social development. Private entrepreneurs succeed in today's China in part by capturing business opportunities in areas prioritized by the government and which are not well-served by the state-owned sector. Enhancing the quality of health care services, facilitating e-commerce, and improving regional logistics services are prime examples of rapidly expanding niche areas of private sector growth. The five-year planning process is well ingrained in government cultures, provides reasonably clear guidelines for the prioritization of future investments (e.g., the naming of "strategic emerging industries"), allows for the identification of regional growth and investment priorities (e.g., the 12th Five-Year Plan for the Development of the Western Regions⁸) and, as such, allows both state-owned and privately-owned businesses to develop strategies that direct investment toward complimentary objectives. For these reasons, the development of 5YPs in China is likely to remain a fixture of government activity for the foreseeable future. In China today, Leading Small Groups are increasingly called upon to oversee important initiatives; it remains to be seen what the role of these groups will be in development and oversight of the 13th 5YP.

⁵ *Wall Street Journal*, <http://www.wsj.com/articles/china-confronts-new-normal-of-slower-growth-1421767359>

⁶ Initial formal drafting of the central government 5YP document began in April 2015, and will continue until the first draft is released in October of 2015 for comments

⁷ The World Bank and Development Research Center of the State Council, "China 2030", 2012.

⁸ The State Council Officially Approves the 12th Five-Year Plan for the Large-Scale Development of the Western Regions: February 13, 2012, http://hk.lexiscn.com/latest_message.php?id=62638

Impact of the 5YP on the business environment in China

The central 5YP is drafted under a process overseen by the NDRC and sets the tone for economic development at a national level for areas such as GDP targets, sector development and transition priorities, social agenda priorities, and the identification of strategic industries. This direction is then implemented through 5YPs drafted by other divisions of the central government, provincial, municipal, and county-level governments, as well as agencies and SOEs.

Historically, 5YPs have served as the central aligning mechanism for cascading national guidelines into local level planning and action. Domestic companies are clearly heavily influenced by the tone and direction of initiatives set out in the 5YPs. An example of this is the inclusion of Outbound Direct Investment in the 12th 5YP in 2011/12 and the government's encouragement for Chinese companies to "go out" through overseas mergers and acquisitions.^{9,10} Since then, China's outbound investment has grown at a compounded annual rate greater than 20 percent.¹¹ It is noteworthy that an increasing share of outbound merger & acquisition activity from China is being undertaken by privately-owned companies. Similarly, the most effective foreign companies operating in China analyze national strategies outlined in 5YPs and adapt business strategies to meet China's stated needs.

In general, China has a good track record of achieving goals set out in 5YPs. According to a mid-term review of the 12th 5YP (2011 – 2015) conducted by the US–China Business Council, China will likely achieve most social and economic goals set out in the plan. These include growing the economy at a rate of at least 7 percent, increasing the services sector contribution to GDP by 4 percent, raising urban and rural income levels 7 percent per year, and increasing the national urbanization rate from 47 to 51 percent.¹² An official assessment report of the progress achieved towards the goals set out in the 12th 5YP is expected toward the end of 2015.¹³

2. 5YP propels expansion of the services sector

Investment is now nearly 50 percent of China's economy.¹⁴ To sustain future growth China's economy needs to be less dependent on fixed asset and real estate investment. To rebalance investment contributions to GDP, policy makers have committed to liberalize the services sector and expand domestic consumption to spark new engines of growth.

China's services sector in 2014 reflected a 46.9 percent share of total economic activity, which is below the 55 percent average share for OECD middle-income countries. By this measure, China's economic contribution from the services sector is more similar to that of Vietnam (43.3 percent) and Indonesia (39.0 percent) than traditionally-compared BRIC

⁹ Chapter 52 of the 12th 5YP, <http://baike.baidu.com/view/4659715.htm>

¹⁰ KPMG, Overview of the 12th Five Year Plan, <https://www.kpmg.com/cn/en/IssuesAndInsights/ArticlesPublications/Documents/China-12th-Five-Year-Plan-Overview-201104.pdf>

¹¹ World Bank data, KPMG analysis

¹² *China Business Review*, Understanding China's 13th Five-Year Plan, <http://www.chinabusinessreview.com/understanding-chinas-13th-five-year-plan/>

¹³ China's 12th Five Year Plan, <http://wenku.baidu.com/view/129137ec0975f46527d3e100.html>

¹⁴ World Bank data, Investment is measured here as gross capital formation as a percent of GDP

countries (Brazil 69.3 percent, Russia 59.9, and India 57.0).¹⁵ The 2013 Third Plenary Session of the 18th Communist Party of China Central Committee (Third Plenum) outlined how China will likely expand the services sector which over time could rebalance investment's contribution to GDP. These recommendations focused on removing subsidies on the cost of capital, diversifying ownership of state assets, and encouraging private sector investment in the services sector.^{16,17}

Removing subsidies on the cost of capital

Historically, China's banking sector has largely focused on supporting manufacturing and other industries dominated by State-Owned Enterprises (SOEs) through subsidized deposit rates and artificially low interest rates, which lower the cost of capital for some companies. Capital intensive industries like manufacturing and infrastructure development require longer funding cycles and considerably larger rounds of funding than comparable service companies. As subsidies are reduced, raising the cost of capital for SOEs in capital intensive industries, available capital will likely flow more to private companies and those in less capital-intensive industries such as services. We are already beginning to see effects of this policy shift. Data shows that year-over-year fixed asset investment growth rates in the manufacturing and real estate sectors have decreased by 13.5 percent and 22.4 percent respectively between 2010 and 2014. In contrast, fixed asset investment growth rates in information technology and healthcare have increased by 44.6 percent and 11.7 percent during the same timeframe.¹⁸

Diversifying ownership of state assets in the services sector

The ownership diversification of SOEs under a program of overall SOE reform was featured in the 12th 5YP, and will likely remain a central component of the forthcoming plan. Policy announcements at the 2013 Third Plenum gave a clear indication how this will be carried forward. "The Decisions" released in November 2013 by the Central Committee called on SOEs to develop more diversified ownership structures that incorporate private, and even foreign, investment.^{19,20}

We are seeing the results of this policy action translated into market activity. The first major announcement was the February 2014 initiative by China Petroleum & Chemical Corporation (Sinopec) to sell 30 percent of its downstream oil services business to private investors. This landmark event was followed later that year with the announcement that six more central SOEs will experiment with what the government calls "mixed ownership" models. China National Building Materials Group and China National Pharmaceutical Group Corporation (Sinopharm) are reported to be among the first of the six.²¹

¹⁵ Service Sector Reform in China, Peterson Institute for International Economics, <http://www.piie.com/publications/pb/pb15-2.pdf>

¹⁶ Service Sector Reform in China, Peterson Institute for International Economics, <http://www.piie.com/publications/pb/pb15-2.pdf>

¹⁷ *Brookings*, Cheng Li: '18th Party Congress' Third Plenum another Turning Point in China's Economic Development <http://www.brookings.edu/blogs/brookings-now/posts/2013/11/china-communist-party-third-plenum-turning-point-economic-development>

¹⁸ China National Bureau of Statistics

¹⁹ *Brunswick Group*, China & the Third Plenum, <http://www.brunswickgroup.com/media/229639/Brunswick-China-Analysis-Third-Plenary-Session-Part-2-November-2013.pdf>

²⁰ The Decision on Major Issues Concerning Comprehensively Deepening Reforms in brief, http://www.china.org.cn/china/third_plenary_session/2013-11/16/content_30620736.htm

²¹ *Financial Times*, <http://www.ft.com/intl/cms/s/0/07928638-0c24-11e4-a096-00144feabdc0.html?siteedition=intl#axzz3X67cdorW>

3. Urbanization and the Five Year Plan

China's 12th 5YP – issued under the leadership of President Hu Jintao and Premier Wen Jiabao – was notable for introduction of the principles of “higher quality growth” and “inclusive growth” as China began a series of significant initiatives designed to extend the benefits of China's economic growth accomplishments toward a larger proportion of the population. Over time, and under the subsequent stewardship of Premier Li Keqiang, these principles were integrated with additional goals included in the 12th 5YP and re-emphasized with the release of the *National Plan on New Urbanization (2014-2020)*, released in March of 2014. Goals present in the 12th 5YP that were brought under what eventually became known in China as “New-Type Urbanization” included increasing the urbanization rate, developing affordable housing, improving access to and affordability of quality health care, increasing access to education, and improving sustainability measures in China's cities and surrounding land and waterways.

In this context, China's municipal managers face a raft of rapid growth-induced challenges, including dangerous air, water and soil pollution levels, inadequate urban health care facilities, and over-loaded educational institutions. To draw on some of the most commonly cited statistics, air pollution levels in the capital routinely reach levels in excess of 20 times those considered safe by the World Health Organization (WHO),^{22,23} while 60 percent of China's renewable ground water is polluted beyond safe drinking levels.²⁴ A recent study conducted by a consortium of leading foreign and Chinese educational institutions²⁵ calculated that air pollution is, when controlling for other variables, reducing the lives of those living in the northern half of China by an average of 5.5 years.²⁶

While urbanization was highlighted in the 12th 5YP, it became a more prominent policy tool guiding growth when Li Keqiang assumed the position of Premier in China in 2013. One can argue that a unique aspect of urbanization in China is that policies guiding urbanization are utilized as distinct growth policy tools, as opposed to urbanization being the byproduct of related growth- and efficiency-targeted policies (which naturally result in higher concentrations of people living in cities). As such, urbanization in China is routinely viewed as the “cause” of growth, not the “effect” of growth and is diligently managed as a policy tool.

China's “New Type Urbanization”

The *National Plan on New Urbanization (2014-2020)* specifically calls for directing population movements based on city population size, stating that “growth in population will be “fully encouraged” in small towns, “moderately encouraged” in small cities (population 500k-1m), “reasonably encouraged” in medium size cities (1m-3m), “carefully analyzed” in large cities (3m-5m), and “strictly controlled” in mega cities (>5m).²⁷ Urbanization related policy initiatives, such as Hukou²⁸ reform, have aligned to this concept. Local residence permits, known as “Hukous” were initially liberalized to incent population

²²WHO Public Health, Environmental and Social Determinants of Health (PHE) http://www.who.int/phe/health_topics/outdoorair/en/

²³ Beijing air quality monitor <http://beijing.usembassy-china.org.cn/070109air.html>

²⁴ Wall Street Journal, Apr 23, 2014 <http://blogs.wsj.com/chinarealtime/2014/04/23/chinas-water-glass-more-than-half-polluted-report-says/>

²⁵ Contributors were the Massachusetts Institute of Technology, Tsinghua University, Peking University and the Hebrew University of Jerusalem

²⁶ *Financial Times*, China smog cuts 5.5 years from average life expectancy, <http://www.ft.com/intl/cms/s/0/eed7c0be-e7ca-11e2-9aad-00144feabdc0.html#axzz3VWypbj8C>

²⁷ *National Plan on New Urbanization (2014-2020)*, Chapter 6, Section 2, March 16, 2014

²⁸ China's national system of local residence permits

movement into smaller towns within the pilot reform locations of Chongqing, Henan, Guizhou, Shanxi, Qinghai, Jiangxi and Anhui.²⁹

Despite the challenges of undertaking such large-scale reform, the period governed by the 12th 5YP (2011-2015) saw significant progress in the quality of life measures associated with “new urbanization”. China is on track to meet or exceeded its stated 12th 5YP goals by raising the national urbanization rate from 47.4 percent to 53.1 percent, expanding access to healthcare, extending average life expectancy by one year, and increasing the high school enrollment ratio from 82.5 percent to 88.9 percent^{30,31}. Perhaps the most significant change relating to the goals of “higher quality growth” and “inclusive growth” arise in the area of governance and performance monitoring. Notably, the Key Performance Indicators (KPIs) applied to monitor a government official’s job performance were amended in several provinces and cities to move away from the previous, long-standing single-measure KPI of GDP growth. Those KPIs now include broader quality of life factors such as poverty reduction and environmental improvement measures.³² We expect more of these measures in the 13th FYP, with particular emphasis paid to environmental and sustainability initiatives – and the associated economic transformation – targeted for the Beijing-Tianjin-Hebei region.

Financing China’s urbanization

Creating more environmentally sustainable cities will be costly, and comprehensive funding mechanisms are yet unclear. Local governments currently are allocated approximately half of collected taxes in China but are responsible for a large majority of expenditures. Since local governments lack significant means by which they can raise capital, budgetary shortfalls have historically been made up through land sales, bank loans, and loans from non-bank entities (“shadow banks”). As a result, local government debt-to-GDP ratios rose quickly over the past 5 years from 10 percent in 2008 to 30 percent in 2013.³³ The forthcoming 13th FYP will likely incorporate a number of important reforms to provide a more sustainable mechanism by which cities are able to fund future urbanization initiatives.³⁴ Reforms will likely include the development of a more robust municipal bond market, alternative local government revenue channels such as personal property taxes, licensing fees, and vehicle taxes, and additional funding frameworks that include Public Private Partnerships (PPP).

Public Private Partnerships (PPP)

The central government has recently shown increased interest in promoting PPPs, especially in the areas of public infrastructure construction and urban public services. Infrastructure projects may include rail development, public hospitals, vocational schools and universities, as well as urban infrastructure and public services anchored around smart cities. Market-driven practices such as franchising, competitive pricing, financial subsidies and other such transparent methods will be utilized to attract private capital to urban infrastructure development.³⁵

²⁹ *The Diplomat*, China Announces Limited Hukou Reform, <http://thediplomat.com/2014/07/china-announces-limited-hukou-reform/>

³⁰ *Xinhua*, Key targets of China’s 12th five-year plan, http://news.xinhuanet.com/english2010/china/2011-03/05/c_13762230.htm

³¹ World Bank Data, KPMG Analysis

³² *Financial Times*, <http://www.ft.com/cms/s/0/2c822efc-a51d-11e4-bf11-00144feab7de.html>

³³ China’s viewpoint: China’s debt, risk of debt crisis, and deleveraging. Bank of America Merrill Lynch, 08 October 2013

³⁴ *China Daily*, 62 sites in country to pilot new urban plan, http://www.china.org.cn/china/2014-09/17/content_33531429.htm

³⁵ China’s Ministry of Finance. China’s National 2014-2020 Urbanization Plan

The central government has identified PPPs as a useful source of funding to meet China's urbanization goals. Following China's *National New-Type Urbanization Plan (2014-2020)*, the government is taking steps to align the performance evaluations of city mayors to the long-term success of such projects. In addition, legal frameworks may be introduced to include regulatory oversight and dispute resolution at the national level, which would better protect the interest of the private investor, and ensure a more transparent legal landscape. We expect central government support for PPP to feature prominently in the 13th Five Year Plan.

4. “One Belt One Road”

The “One Belt One Road” strategy is composed of two main initiatives: the Silk Road Economic Belt (“One Belt”) and the 21st Century Maritime Silk Road (“One Road”). These initiatives were proposed by President Xi Jinping during state visits to Kazakhstan and Indonesia in September and October of 2013, respectively.³⁶ Further details on the “One Belt One Road” plan were released in late March 2015. China hopes that through these two strategies, it can better integrate its economy with that of Europe, increase its soft power influence in the developing world, and transfer domestic manufacturing output to neighboring nations to meet rising demand in sectors where China is burdened with over-capacity. Similarly, Beijing hopes to address the domestic east-west development gap by building infrastructure in under-developed regions such as Xinjiang. China's announcement of the Asian Infrastructure Investment Bank puts Chinese capital – and that of other participating countries – behind this strategic initiative. To further fund this initiative, China has announced a USD 40 billion Silk Road Fund. Measures that integrate the policies supporting inland regional development, infrastructure investment, and regional economic trade with China's western neighbors under the label of the “One Belt One Road” initiative are expected to be featured prominently in the 13th Five Year Plan.

5. “Mass Entrepreneurship and Innovation”

Premier Li Keqiang announced a new campaign referred to as “Mass Entrepreneurship and Innovation” as part of the Government Work Report he presented at this year's “Lianghui” (Two Sessions) annual government meeting. This campaign is designed to encourage entrepreneurship and innovation to spur economic growth in China's “New Normal” economic phase of slower growth and less reliance on investment. Intended outcomes of the initiative appear to include a more “level playing field” for entrepreneurs and better access to government-controlled business services such as bank loans. As a result, we may see more focus intellectual property rights protections for entrepreneurs, and more clarity in regulations around flexible financing mechanisms targeted toward small- and medium-sized enterprises. The intent of the government appears to be to increase availability of capital for more innovative sectors that will create more employment opportunities, especially for higher skilled workers and college graduates.

³⁶ Chronology of China's Belt and Road Initiative, Xinhua News Agency, 28 March 2015, http://news.xinhuanet.com/english/2015-03/28/c_134105435.htm

6. Opportunities within the 13th 5YP for American companies

Although actual drafting of the 13th 5YP has only recently begun, senior government officials, including Premier Li Keqiang, are commenting on its potential contents and messaging. The Premier noted that the 13th 5YP should “not only focus on the five years and reflect diversified goals for building a moderately prosperous society by 2020, but also consider development prospects in the longer term”.³⁷ To meet that goal, we will likely see a transition in emphasis from hard economic or demographic targets to a set of more balanced targets that seek to “improve government efficiency and credibility”.³⁸ American companies that have the technology, know-how, and innovation to help China achieve its next set of goals can contribute to China’s further development in ways consistent with the goals encapsulated in the 13th 5YP.

China faces a dauntingly complex array of challenges as it undertakes implementation of the 13th 5YP. Enhancing access to health care services, improving air quality, increasing the efficiency of energy production, raising the quality of environmental standards, improving agricultural efficiency, enhancing education quality, improving the quality of national logistics networks, encouraging innovation and facilitating start-up platforms, enhancing infrastructure in targeted regions, building “smarter cities”, expanding advanced manufacturing capabilities, and spurring e-commerce and information technology capabilities are several of the most critical objectives likely to emerge in the 13th 5YP. China’s domestic enterprises – whether public or private – cannot address these needs entirely on their own. American companies have significant opportunity to fill this void, and can be aided in that process from American initiatives that seek to study 5YP guidelines in depth, and align policy toward mutually beneficial commercial objectives.

³⁷ *China Daily*, 2014-09-05, http://www.chinadaily.com.cn/china/2014-09/05/content_18550923.htm

³⁸ <http://www.chinanews.com/gn/2012/03-06/3722104.shtml>