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China's Third Plenum May Be More Than Just Talk

by

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Big promises

The 3rd Plenum of the 18th Party Congress, scheduled for November 9-12, will serve as a platform for China's new leadership to unveil economic policy changes.* China's economic growth is slowing and the new leadership has adopted the shift recommended in the 12th Five Year Plan to an economic model driven more by consumption and innovation than by state-led investment and export growth. At a meeting this week with international policy-makers, President Xi Jinping pledged a "comprehensive reform plan" that will "give overall instructions on the widely deepened reform and opening up."¹ In early October, he described the reforms to be outlined in the Plenum as a "profound revolution."² Yu Zhengsheng, the fourth-ranked leader in the party hierarchy, also recently referred to the upcoming reforms as "unprecedented."³

Likely to be short on specifics

Despite such grand pronouncements, most experts are forecasting gradual reforms rather than radical progress as China's new leaders build support for reforms that may work against the vested interests of the wealthy and the state-owned sector. Moreover, since China's party plenums typically set the general direction and principles of reforms that lower levels of the bureaucracy later flesh out with regulations and laws, it is not unusual for the policy prescriptions coming out of these meetings to be broad and vaguely defined.⁴

The 383 Project

On October 27, the Development Research Center (DRC), a top think-tank that reports to the State Council,[†] released reform proposals for the 3rd Plenum, dubbed the "383 Project." This is shorthand for three key themes, eight key reform areas, and three correlated reform combinations outlined in the recommendations. The fact that one of its co-authors is Liu He, a key economic adviser to President Xi, has focused much attention on the paper's recommendations. However, the 383 Project is one of many presented to the leadership, and is the articulation of particularly reform-minded forces embodied by Liu. Arrayed against it would be those who oppose sweeping changes, such as the state-owned enterprises, the state-owned banks and the exporting manufacturers. Acceptance of the 383 Project ideas is far from guaranteed. An agenda like the one articulated by the DRC "could be wide-ranging and significant or it could be minor and incremental, depending on how it is turned into actual policies and how it is implemented," according to the *Financial Times*.⁵

- **3 Key Themes**
 1. Improve the market system
 2. Transform the role of government
 3. Build an innovative corporate structure

- **8 Key Reform Areas**
 1. Government
 2. State monopoly sectors

* This plenum will be the third meeting of the 376 members of the 18th CCP Central Committee (the central committee formed during the 18th Party Congress in November 2012). Each Central Committee is elected for a five-year term, and holds a number of plenums to discuss and approve major policy decisions. The third Plenum traditionally focuses on economic policy.

[†] The Development Research Center is viewed by many as China's most influential government-affiliated think tank when it comes to economic and social policy. Its policy suggestions tend to be liberal and market-oriented, and it works closely with international organizations. For instance, the DRC and the World Bank coauthored the report *China 2030: Building a Modern, Harmonious, and Creative Society*, in February 2012.

3. Land ownership and administration
 4. Financial sector
 5. Tax system
 6. Management of state assets
 7. Innovation
 8. Further opening-up of the economy
- 3 Correlated Reform Combinations
 1. Enhancing competition
 2. Deepening social security reform
 3. Deepening land reform

3rd Plenum forecasts by issue area

President Xi has hinted at areas that may be key targets for reforms: "We are currently changing our way of development, adjusting our economic structure, accelerating our new style of industrialization, promoting technology, urbanization and agricultural modernization."⁶ Some of the forecasts for specific issue areas are summarized below:

- Financial System—The debate over the need for financial system reform has largely been won, so there will likely be more detailed reform plans for the financial system than for many other issue areas. These may include: goals to loosen controls on the exchange rate; liberalization of interest rates to allow banks to compete on depositor rates; further opening of the country's capital account to allow more cross-border cash flows; and closer regulation of shadow banking.
- Fiscal Policy—Financial sector reforms are likely to be complemented by some degree of fiscal reform, with a view toward mitigating local government debt, improving government welfare provision, and placing a greater tax burden on the wealthier actors in the economy, such as SOEs and the top 10 percent of income earners.
- State-Owned and State-Controlled Enterprises—State-backed industrial monopolies often work against the leadership's efforts to foster innovation and bolster the private sector. Although pronouncements emphasizing the importance of expanding opportunities for the private sector are likely, it is less likely that the 3rd Plenum will prescribe forced breakups of state-controlled monopolies in finance, telecoms and other sectors, let alone privatizations of state-owned companies.
- Rural Land Reforms—Speculation has centered on granting farmers stronger legal titles over the land they lease. The present system of collective ownership, overseen by local party leaders, has incentivized rampant land seizures for commercial use in ways that benefit local coffers, corrupt officials, and property developers at the expense of individual landholders. This system has fomented popular unrest, and there is growing pressure to create a rural property market, which would bolster rural economic reform and facilitate urbanization. As with SOE reforms,

however, strong vested interests are likely to be aligned against any such changes.⁷ A major obstacle for reform is that local governments do not have a steady tax revenue stream; following fiscal reforms in 1994, a large part of China's tax base was reallocated to the central government. As a result, local governments rely heavily on land seizures and sales to fund spending, often for industrial projects that in turn generate business taxes. One potential reform, therefore, is to give provincial and local governments the power to sell bonds to raise revenue and finance building projects. Another possibility is to allow farmers to more freely transfer land use rights to third parties or, at the very least, to receive market-based compensation for land seizures.

- **Urbanization**—Since Premier Li has championed urbanization, some reform of the *hukou* system is expected. However, a major overhaul is unlikely given the massive costs of extending social services allocated to *hukou* holders to all of the estimated 250 million migrant workers currently living in China's cities without these residency permits.⁸ Local officials fear the expense of an unfunded mandate to provide migrant families with health care, free education, and pensions.

Debates among Chinese experts

The Chinese-language media has canvassed the views of Chinese experts from industry, government, and the research community. Among the better known experts who have presented their views are (1) Wang Xiaolu and (2) Jia Kang, Deputy Directors of the China Reform Foundation's National Economic Research Institute; (3) Cui Li, chief China economist at Bank of Scotland and formerly of the IMF and the Hong Kong Monetary Authority; (4) Wang Tao, chief China economist at the Swiss bank UBS; and (5) DRC Agriculture Research Institute Director Xu Xiaoqing. The *21st Century Business Herald* (21 Shiji Jingji Baodao), a leading business daily, and *Global Times* (Huanqiu Shibao), a state-controlled but outspoken daily paper, have covered the 3rd Plenum buildup more extensively and candidly than the official Xinhua News Agency.

A reaction to the 383 Project was published in the editorial section of the *Global Times* on October 30. Many think tanks supported the DRC's proposals, yet the article argued the document represented a minority view within the political establishment. The op-ed argued that any future reform initiatives would have to take into account the views of China's broader public, especially on the Internet, rather than just those of reform-minded researchers in state-sponsored agencies.⁹

Divided by issue area, Chinese expert insights include:

- **Financial System**—Wang Tao and Cui Li, speaking for the financial services industry, cautioned that the government cannot jump the gun on internationalizing the RMB or liberalizing deposit rates, two of the key measures promoted by reformers. The RMB can only become an invoicing currency on a large scale if China frees up its capital accounts. Likewise, any reform of deposit rates will require better insurance schemes to protect depositors against bank defaults. The 3rd Plenum must make progress on these incremental reforms first.¹⁰
- **Fiscal Policy**—Wang Xiaolu and Jia Kang opined that fiscal policy is central to China's overall reform agenda, as it impacts social welfare. Local governments bear more responsibility for providing services and welfare but are not allocated a commensurate share of tax revenues.

According to Jia Kang, the reform goal is not to give local authorities more taxation power, but rather to ensure that in each area of administration, provincial and municipal officials provide adequate public goods and have the requisite funding to do so. Policing debt at the local level and rooting out corruption is also critical in this regard. So is establishing a market for local government bonds, which would boost the financial sector while providing local authorities with more revenue. Wang and Jia also made the case for altering the composition of tax revenue. Reducing reliance on the value-added tax, which is highly regressive, includes increasing the tax breaks awarded to small and medium-sized enterprises, where coverage is currently limited to a select few sectors under a government pilot scheme. In addition, income tax, which is currently levied more heavily on corporations than on wage income, and much less on private wealth, needs to be restructured. On a broader level, there is a need to bring social welfare funding (the equivalent of Medicare), state-owned assets, and the rest of the budget under one umbrella. A harmonized budget would facilitate more funding social welfare instead of infrastructure.¹¹

- State-Owned and State-Controlled Enterprises—Wang Tao of UBS did not rule out a 3rd Plenum decision to turn over more SOE shares to the National Social Security Fund, to contribute to China’s future retirement provision. But most industry experts in China were skeptical about the government’s ability to level the playing field for the private sector, especially in industries now dominated by SOEs. The 383 Project proposed radical industry restructuring to break the triple telecom oligopoly of China Mobile, China Unicom, and China Telecom, which would lower the costs of broadband access for consumers. Yet, experts noted that such reforms were already attempted in 2008 and 2010, with limited success, because the three SOEs that dominate the market control the key infrastructure, have invested heavily in forthcoming 4G networks, and are eager to retain their quasi-monopolies. It is more realistic for the Big 3 to contract smaller private companies for resale services, something already started in a pilot program this year. Indeed, the debate about SOE reform seems to focus more on how different SOEs should compete along the value chain: for instance, radio and television network providers could compete with the telecoms providers, while in the rail sector, rail services providers could operate independently of the Railway Ministry, which currently oversees both railway infrastructure and services.¹²
- Rural Land Reforms and Urbanization—Among the proposals set forth in the 383 Project, land reform generated the most debate in China. The central controversy is not only whether to give farmers more land rights, but also whether to create a unified property market in which the land owned by collectives in rural areas is transferrable with state-owned land in urban areas. A huge grey market has appeared on the fringes of China’s expanding cities, as urban migrants have built makeshift residential infrastructure (akin to shantytowns) on land nominally owned by rural collectives. In some cases, informal, mutually beneficial transactions take place between farmers and urban migrants. In other instances, legal disputes arise and are not properly litigated. Moreover, the government reserves the right to declare this new infrastructure, or “small property”, illegal and tear it down at will. Some experts argue that harmonizing the property market, and according property rights to shantytown residents, will be beneficial to

China's urban development and household welfare. Others argue that the first step is rural land reform, and are pessimistic that a more radical reform of urban and rural land law will be possible. Indeed, in a marketized system where a higher price tag is placed on land, many rural residents who currently depend on their land for insurance may be exploited in new ways.¹³

Table 1: Potential reforms

The following is a list of specific reform priorities the 3rd Plenum could address:

Table 1: Potential reforms

Area	Reform	Content of reform	Main objectives
Welfare	Hukou reform	Provide full residency status to rural migrants residing in cities, including access to local healthcare, schooling, and other public goods	Improve income distribution; mitigate labor market and demographic imbalances; boost consumption and reduce precautionary savings
	Rural land reform	Transition from a land lease to land ownership system	
	Increased social expenditure	Significantly increase spending on health care, social security, and education as a percentage of GDP	
	Pension reform	Develop a nationwide system for the basic pension; slowly expand coverage of the mandatory contributory system with a primary focus on large firms in urban and rural areas; more transparent accounting	
Public administration	Budget transparency	Require all officials to publish details of their wage and non-wage income	Reduce corruption
	Intra-party democracy	Allow all citizens to vote for local Communist Party candidates	Expand electoral democracy
	NGO registration	Transition from approval to registration system	Expand civil society participation
	Outsourcing	Allow profit and non-profit organizations to compete for government contracts. assume public goods provision on behalf of government agencies	Democratize welfare provision
Monetary policy and banking regulation	Interest rate liberalization	Lift 3% ceiling on deposit rates in order to fully eliminate the benchmark deposit and lending rates and switch the target of monetary policy from money supply to benchmark policy rate (7-day repo rate)	Improving allocation of financial resources; providing consumers with investment alternatives to real estate speculation; reduce precautionary savings; enhance risk management at private banks.
	Better regulation in the banking system	Greater role for private sector in lending and borrowing; better regulation of the "shadow banking" sector	Improve allocation of financial resources; prevent systemic risks to the financial system; consumer protection from risky Wealth Management services.
	Exchange rate flexibility and capital account liberalization	Let market determine the exchange rate; remove most restrictions on FX conversions and cross-border capital flows	Reduce external imbalances; permit global allocation of financial resources; promote RMB internationalization and its use as a reserve currency; allow Chinese workers more options for investment gains

Area	Reform	Content of reform	Main objectives
Fiscal policy	Central-local fiscal revenue distribution	Allow local governments to collect a larger share of national tax revenue; allow more local governments to raise bonds	Encourage local governments to rely less on off-balance sheet financing (e.g. quasi-government financing vehicles), land sales, business taxes, and local SOE profits to generate revenue
	VAT reform	Replace business revenue tax on service industries with a VAT tax at a reduced rate in all regions.	Accelerate growth of service industry; give special rebates to SMEs to encourage private sector; boost consumption of services; put services on an equal playing field with manufacturing
	Resource and environment tax reform	Increase tax rate on resource consumption and on waste discharges	Reduce excessive use of natural resources and pollution discharges, raise more fiscal revenue
	Personal income tax reform	Expand tax base beyond salaries to non-wage income such as capital gains and property rental income; reduce number of tax brackets; Lower the top rate; initiate pilot program for global income tax system	Redistribute income and raise more revenue; reduce income disparity; fund government more equitably; reduce tax evasion
	Property tax reform	Combine multiple land and property taxes and fees into one uniform tax; raise the property tax rate, in combination with better management of local government fiscal income and expenditure	Help local governments transition from "off-balance-sheet" land revenues (e.g. land leasing fees) to transparent tax system; reduce local government's fiscal burden; expand the tax base
Corporate regulation	Private enterprise reform	Transition from approval to registration system; transparent system of government procurement and licensing; equal access to funding for private firms, especially small and medium-sized enterprises	Raise efficiency and productivity; level the playing field between the private economy and the state sector
	Foreign investors	Transition from approval to registration system; transparent system of government procurement and licensing; equal access to funding to eliminate limits on equity participation in certain industries	
	SOE reform	Privatization, incl. foreign M&A; raise the requisite dividend payouts to shareholders, including local governments; reduce the incidence of non-performing loans	
Energy policy	Power tariff reform	Introduce more flexible, market-based pricing to account for changes in input costs; sliding scale mechanism based on household income	Normalize margins and raise the return on equity of upstream industries to encourage investment in more efficient technologies; reduce excessive resource consumption by industry; improve income distribution
	Gas tariff reform		
	Water tariff reform		
	Refined oil pricing reform		

Source: Compiled by Commission staff; Deutsche Bank, China Strategy: Reforms after Leadership Transition (November 2012), pp.8-9; Nicholas Barr & Peter Diamond, "Pension Reform in China: Issues, Options, and Recommendations," working paper, February 6, 2010.

Table 2: Summary of 3rd Plenum Sessions, 1978-2008

Event	Date	Main documents	Major economic policy measures
11th	Dec 18-22, 1978		Discussion on the criterion of truth ("seeking truth from facts"); shift the focus of the Party's work to economic work and socialist modernization; start the rural area reform.
12th	Oct 20, 1984	"CPC's decision on economic reform"	Reform moves from the rural to urban areas. Speed up the city-centered economic reform, including enhancing the vitality of enterprises, developing the socialist commodity market, establishing a reasonable pricing system, improving the tax regime and reform the financial system.
13th	Sep 26-30, 1988	"A preliminary proposal on pricing and wage reform"	The economic work in the next two years will focus on rectifying the disorder phenomena in the economy; implement pricing and wage reform in the next five years or a longer period, and contain the inflation pressure at the same time.
14th	Nov 11-14, 1993	"CPC's decision on the establishment of the socialist market economic system"	The master plan of establishing a socialist market economy. The details include: the establishment of modern enterprises; the transformation of government functions; the establishment of reasonable income distribution and social security system; promoting economic openness.
15th	Oct 12-14, 1998	"CPC's decision on agriculture and rural works"	Set up the target of a new socialist rural area with Chinese characteristics by 2010; adhere to household contract management (or household responsibility system) as a basic system, with land contract to be extended for another 30 years.
16th	Oct 11-14, 2003	"CPC's decision on improving the socialist market economic system"	Public ownership is dominant supplemented by various forms of ownership; shareholding is the major form of public ownership; proposed for the first time the establishment of a modern property rights system; non-public enterprises can enter all sectors without explicit legal prohibition; deepen the SOE reform and the rural reform.
17th	Oct 9-12, 2008	"CPC's decision on rural reform and developments"	Adhere to the household contract management system, improve the rural land management system; establish a modern rural financial system; develop modern agriculture.

Source: Moran Zhang, "China's third plenary session of 18th CPC Central Committee: 8 things to know about China's Party Congress and its reform agenda," *International Business Times*, November 1, 2013. http://www.ibtimes.com/chinas-third-plenary-session-18th-cpc-central-committee-8-things-know-about-chinas-party-congress_

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² "A world to turn upside down," *The Economist*, November 2, 2013.

³ Jamil Anderlini, "China's grandees ready for crucial political event," *Financial Times*, November 3, 2013. http://www.ft.com/intl/cms/s/0/133eed50-44ab-11e3-8926-00144feabdc0.html#axzz2jiAzsB7D_

⁴ Jamil Anderlini, "China's grandees ready for crucial political event," *Financial Times*, November 3, 2013. http://www.ft.com/intl/cms/s/0/133eed50-44ab-11e3-8926-00144feabdc0.html#axzz2jiAzsB7D_

⁵ Jamil Anderlini, "China's grandees ready for crucial political event," *Financial Times*, November 3, 2013. http://www.ft.com/intl/cms/s/0/133eed50-44ab-11e3-8926-00144feabdc0.html#axzz2jiAzsB7D_

⁶ "China President Xi confident about healthy economic growth," *Reuters*, November 2, 2013. http://www.baltimoresun.com/business/sns-rt-us-china-president-20131102,0,1586801.story_

⁷ Andrew Browne, "Political Gridlock, Beijing Style," *Wall Street Journal*, October 29, 2013.

⁸ Andrew Browne, "Political Gridlock, Beijing Style," *Wall Street Journal*, October 29, 2013.

⁹ "Sheping: '383' baogao yinling gaige jianyi zhide guanzhu" (Op-ed: '383' Report Is Worth Heeding), *Global Times*, October 30, 2013, via Factiva.

¹⁰ "Sanzhong Quanhui si da gaige kandian ji touzi zhuti" (Four Major Aspects and Three Major Investor Theme of the 3rd Plenum), *21st Century Business Herald*, November 6, 2013, via Factiva.

¹¹ "Caishui tizhi gaige da silu" (Broad Perspectives on Fiscal Policy Reform), *21st Century Business Herald*, November 4, 2013, via Factiva.

¹² "383 gai ge 'dianxin chongzu' yin zhengyi: huo cu guojia ji guangdianwang cheng disi yunyingshang" (383 Reform 'Telecoms Restructuring' Proposal Incites Controversy: May Lead Radio and TV Network Providers to Become Fourth Competitor), November 6, 2013, via Factiva; "Sanzhong Quanhui si da gaige kandian ji touzi zhuti" (Four Major Aspects and Three Major Investor Theme of the 3rd Plenum), *21st Century Business Herald*, November 6, 2013, via Factiva.

¹³ "Beijing chai xiao chanquan fang wei dong genben: reng zai zhengchang maimai" (Beijing's Small Property Has Not Been Shaken: Transactions Continue), *21st Century Business Herald*, November 6, 2013, via Factiva; "Yi tudi binggui jiaozheng renwei jicha di zu" (Using Uniform Property Markets to Correct Unequal Access to Land Leases), *21st Century Business Herald*, November 5, 2013, via Factiva.