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**China's 2014 Government Work Report:
Taking Stock of Reforms**

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Overview

China watchers took a keener interest than usual when newly installed Premier Li Keqiang presided over his first National People's Congress (NPC), March 5-13. They hoped that the Premier's official report would reveal whether China will take a more reformist direction or adhere to a cautious approach focused on sustaining a high rate of economic growth. The March report came only four months after the Third Plenary Session of the 18th Party Congress, a meeting that produced a lengthy but ambiguous reform blueprint for the coming years. While Premier Li's March report laid out an ambitious agenda, the continued emphasis on growth and the lack of implementation specifics left troubling gaps.

Chinese premiers traditionally open the annual NPC meeting with a "Government Work Report," which highlights the previous year's accomplishments and lays out the major tasks for the current year. Usually a formulaic justification of government policy, the work report supports the annual budget proposal of the Ministry of Finance and the economic and social plans of the National Development and Reform Commission (NDRC).

In a hopeful sign for continued reform, the major tasks for 2014 hew closely to the priorities outlined in the Third Plenum decision: an emphasis on consumption-led growth, a more generous welfare state, an expanded services sector, and welcome policy support for household incomes over industrial output. Major targets to back up these policies include adding 10 million urban jobs; easing residency restrictions for urban migrants; raising per capita funding for basic medical insurance; and expanding the fiscal deficit.

The report also added teeth to Third Plenum proposals to liberalize the financial sector and to clamp down on pollution and inefficiency in the industrial sector. Continuing the pro-market rhetoric of the plenum decision, Premier Li said the government "shall endow the 'invisible hand' of the market with liberty while making use of the 'visible hand' of the administration to foster stable growth."¹ He also promised to further streamline government work by enhancing budgetary transparency, reducing administrative red tape, and clarifying the relationship between central and local authorities.

For all its progressive features, the work report still raised questions about the new leadership's commitment to economic reform and rebalancing. Premier Li, the Ministry of Finance, and the NDRC often failed to provide deadlines or to assign specific responsibilities to agencies. The report set the gross domestic product (GDP) target for 2014 at 7.5 percent for the third year in a row, despite the fact that the GDP growth target set for 2011-2015 in the 12th Five-Year Plan is 7 percent—a clear indicator that the new leadership is nervous about slowing growth triggering unemployment and corporate failure (and, by extension, threatening the country's stability). Raising the household share of national income—a crucial component of rebalancing China's economy toward stronger consumption—got short shrift. The Premier noted that disposable household income rose by 7 percent in real terms but failed to mention that this was less than the rate of real GDP growth, which means that the household consumption share of GDP continues to lag.

Premier Li and the Ministry of Finance asserted that sustaining employment was more important than promoting high growth (although the two are closely linked); yet China's official unemployment figures are highly suspect, because they have remained virtually unchanged over the past decade (see Appendix figure 1). That casts doubt both on the Premier's claim that the unemployment rate was kept low at 4.1 percent in 2013 and on his pledge to keep unemployment at 4.6 percent in 2014. Premier Li's sanguine analysis of economic indicators also raised doubts. For example, money supply growth and inflation were contained last year, but the Premier did not mention the spike in interbank lending rates that unsettled financial markets in June and December. He noted that government revenue rose by 10.1 percent without acknowledging that it was the lowest year-on-year increase since 1991.

* For analysis, see Nargiza Salidjanova and Jacob Koch-Weser, "Third Plenum Economic Reform Proposals: A Scorecard" (Washington, DC: U.S.-China Economic and Security Review Commission, November 19, 2013). <http://origin.www.uscc.gov/sites/default/files/Research/Backgrounders/Third%20Plenum%20Economic%20Reform%20Proposals--A%20Scorecard%20%282%29.pdf>.

Government Work Report Scorecard

This scorecard will provide an overview and assess key points of the work report's plans for financial system liberalization, fiscal reform, administrative reform, environmental regulation, urbanization and rural land reform, and healthcare reform.

Financial System—Specific but conservative liberalization. Premier Li's work report expanded on the vague promises made in the Third Plenum decision to liberalize the financial system:

- **Renminbi (RMB) trading band widened.** Following an engineered drop in the RMB value against the dollar, People's Bank of China (PBoC), the central bank, doubled the RMB's daily trading band to 2 percent. The new band went into effect on March 17. Although this appears to be a step toward RMB liberalization, PBoC will continue to reset the value of the currency within that band every day, controlling its overall movement (and, therefore, any expected appreciation).[†]
- **Deposit insurance scheme and potential removal of deposit ceiling.** The Government Work Report confirmed that China will establish a deposit insurance system this year. A reform measure that has been mulled over for some time, the system sets the stage for liberalizing deposit rates, as it protects depositors against bank defaults. PBoC Governor Zhou Xiaochuan said on the sidelines of the NPC meetings that China will remove the ceiling on bank deposit interest rates[‡] "very likely [...] in one or two years."² The pronouncement was predictably vague but was given credibility by last July's decision to lift the floor on lending rates. Taken together, these moves would mark a significant step toward modernizing China's financial system.
- **Private bank pilots.** Following Premier Li's announcement that the government will promote smaller banks and private financial institutions, the head of the China Banking Regulatory Commission said the government has approved the establishment of five new, privately owned banks by a group of investors—a notable innovation in an industry dominated by a handful of state-owned banks. Although no timetable was provided, the government said the program will be piloted in Shanghai and Tianjin and in the coastal provinces of Zhejiang and Guangdong.
- **Support for Internet finance.** The private bank pilots intersect with Premier Li's intention to exert more government control over the development of Internet finance. Alibaba and Tencent, two of China's biggest Internet companies, are among the 10 investors applying to be involved with the planned private banks (each bank is to have two private co-sponsors). Premier Li said the government would promote the "healthy development of Internet finance," one of his six references to the "Internet" and "e-commerce"—terms not used at all last year by then Premier Wen.³ The challenge for Beijing is that Alibaba and Tencent have already attracted more than \$65 billion in deposits by allowing individuals to invest money directly online in high-yielding financial products.⁴ Extremely popular among younger Chinese, the Internet companies have attracted the ire of China's brick-and-mortar banks (which have lobbied the government to tighten the noose on Internet finance) and of government regulators (who have recently blocked plans by Tencent and Alibaba to offer virtual credit cards).⁵

Fiscal Reform—Promise of budget transparency, tax reforms, and more generous spending. Fiscal reform is a lynchpin for reducing China's public debt, improving government services, and combating

[†] Undervaluing the RMB, which boosts the export sector, has been instrumental in making China a manufacturing powerhouse. The government is therefore unwilling to allow the RMB to appreciate too quickly. Undervaluation has aggravated imbalances in China's economy by making imports more expensive, thereby suppressing consumption and inducing overinvestment in the export-led manufacturing sector. The government is aware of this condition (and of the international criticism of currency undervaluation) and has been allowing the currency to appreciate slowly. Appreciation, however, has attracted speculative currency inflows, driven by speculators betting on the RMB's one-way appreciation. The government has been trying to reduce these "hot money" flows, most recently by engineering a fall in the RMB's value. This had the added benefit of boosting Chinese exporters, who have been struggling in recent months. For more on this subject, see the March 2014 edition of the USCC Trade Bulletin. <http://www.uscc.gov/trade-bulletin/march-2014-trade-bulletin>.

[‡] Currently, the government-set ceiling on deposits allows a 3 percent annual interest rate for benchmark, one-year household deposits and as low as 0.35 percent on demand deposits.

corruption. Fiscal spending by China's central government has been small relative to the size of the economy. The government has instead relied on high rates of household saving funneled through the state-owned banking sector to borrowers, as well as off-balance-sheet fundraising by local governments through quasi-corporate entities known as local government financing platforms.[§] Meanwhile, officials have taken advantage of lax disclosure requirements for fiscal budgets and public officials' incomes in order to embezzle funds. Several proposals seek to improve fiscal policy:

- **Reducing lavish spending.** The new leadership has been carrying out a very public crackdown on corruption, most recently against former Politburo Standing Committee member Zhou Yongkang. Premier Li avoided any mention of the Zhou case; however, the Ministry of Finance emphasized the progress made last year in reducing lavish spending by government officials on travel, entertaining, and other nonessential items. Apparently, more transparent procedures are being put in place to publicize and manage this part of the budget.
- **Managing local government finances.** Without providing specifics, the government said it will allow local governments to raise their own bonds. Under the current system, bonds can be raised by the Ministry of Finance on local governments' behalf, but these only account for a small share of local government revenue. The move would reinforce local government fiscal autonomy—the share of central government fiscal transfers in local revenue in 2014 is projected by the Ministry of Finance to reach its lowest level since 1999 (see Appendix figure 2). The question is what will be done about relieving local government debt. Premier Li claimed that total government debt, at 2.1 percent of GDP, was at a sustainable level last year. Yet the bulk of local government debt is not accounted for on the official government balance sheet. The Ministry of Finance only stated that it “carried out a nationwide inspection of the loans granted by local governments and their special accounts.” Those audits, published in January 2014, raised the specter of default for some local governments.
- **Increasing the fiscal deficit.** The government will continue to grow the fiscal deficit in 2014 (see Appendix figures 3.1 and 3.2). About two-thirds of China's fiscal debt will fall on the central government and one-third on local governments. The central government will continue to devote about 70 percent of its spending to fiscal transfers and tax breaks for local governments.
- **Redistributing the tax burden to encourage economic rebalancing.** Preferential tax policies will be expanded for small businesses and companies involved in R&D-related activity. Deferred payment will be introduced for individual income taxes, to encourage the development of annuity plans in enterprises and public institutions. To quell a potential housing bubble, the Ministry of Finance said it is “accelerating legislation” on a real estate tax. The government will also move to replace business taxes with a value-added tax (VAT), with initial trials to be undertaken in the railway, postal, and telecommunications sectors. This change may be designed in part to preempt “fiscal wars” among local authorities—the VAT is collected by the central government, whereas business taxes are levied (often on a discriminatory basis) by local governments.

Administrative Reform—Removing red tape for investors and new businesses. The government will cancel or delegate to lower-level governments more than 200 administrative examination and approval items in addition to the 416 that were eliminated or delegated last year. Although the previous leadership had already undertaken such streamlining, Premier Li also outlined a regulatory overhaul for new investments and businesses. Preliminary reviews of investments will be abolished or simplified. In line with a “negative list” approach—a method preferred by the United States—the government will provide a list of all investment types that require review and will refrain from reviewing any types not included on the

[§] The International Monetary Fund describes local government financing platforms (LGFPs) as follows: “[LGFPs] provide local governments with corporate platforms to pursue local infrastructure projects. Treated as municipal state-owned enterprises (SOEs) under China's Company Law, LGFPs are the backbone of local governments in promoting infrastructure development in China. They are primarily engaged in the construction of public welfare projects, such as affordable housing construction, infrastructure, social services, and ecological and environmental protection.” Furthermore: “[LGFPs are] the principal financing agents for local government [...]. By not encouraging higher local fiscal deficits or imposing more pressure on local government to issue bonds, LGFPs could, to some extent, be seen as a fortune for Chinese local governments, as they act as a vehicle to provide off-balance sheet quasi-fiscal support for local governments.” Yinqiu Lu and Tao Sun, “Local Government Financing Platforms in China: Fortune or Misfortune?” *IMF Working Paper* 13/243 (Washington, DC: International Monetary Fund, October 2013), pp.3-4. <http://www.imf.org/external/pubs/ft/wp/2013/wp13243.pdf>.

list. In a step toward replacing approvals with a registration system, new businesses will be able to obtain an operating license before receiving a permit. Given the many agencies that participate in the approval process, however, the question is when and how these policies will be implemented. For example, expectations for a negative list in the Shanghai Free Trade Zone, established last fall, have so far fallen short.

State-owned Enterprise (SOE) Reform—No breakthroughs, but momentum sustained. SOE reform was a surprise component of the Third Plenum decision, including a promise to raise the dividend payout ratio of SOEs to 30 percent by 2020, from the current 5-15 percent. The work report did not set any more specific targets but underscored the expectation that SOEs should improve their returns while private sector companies receive encouragement. Perhaps in a sign of things to come, state-owned oil major Sinopec announced in February that it would open its marketing arm to 30 percent foreign investment, a landmark move in a sector tightly controlled by the government.⁶ The government reiterated its pledge from the Third Plenum to allow non-state capital in “finance, petroleum, electricity, railroads, telecommunications, resource development, and public utilities.”⁷

Environmental Regulation—The government will “declare war” on pollution. Building on the promise to promote an “ecological civilization,” and calling pollution a “nature’s warning signal” in response to wasteful development, Premier Li’s work report provided some concrete targets for controlling pollution and reducing energy efficiency:

- **Combating air pollution.** The government will issue measures to reduce emission of PM10 and PM2.5, the small particulates that pose a particular danger to human health. This is especially relevant, as major cities like Beijing and Shanghai have been shrouded in choking smog over the winter.^{††} The government plans to eliminate 50,000 coal-fueled furnaces and six million old and polluting vehicles. Energy consumption will be reduced by 3.9 percent, and the emission of sulfur dioxide and oxygen-consuming chemicals is to be reduced by 2 percent.
- **Retiring excess capacity in polluting industries.** The government announced that its target for reducing outdated production capacity set in the 12th Five-Year Plan would be achieved one year ahead of schedule. Specific targets were given for this year to retire 27 million metric tons of steel, 42 million metric tons of cement, and 35 million standard containers of plate glass. These are among the most polluting industries. The government targets may have been designed merely to impress—no percentages were cited, and the Premier neglected to mention that heavy industry is already operating at low levels due to the weak economy.
- **Higher resource prices, more government spending, and an environmental tax.** The government will introduce a tiered pricing system for water and gas consumption.⁸ In a separate report, the Ministry of Finance said it will levy a price-based resource tax on coal; speed up legislation on an environmental protection tax; and spend RMB 211 billion (around \$34 billion) on energy conservation and environmental protection, an increase of 7.1 percent over 2013.
- **Ambivalence on water pollution.** The government introduced a clean-water action plan. Elsewhere, however, the work report professed its steadfast support for raising the country’s grain and livestock output in the interest of achieving food security. China’s own environmental assessments have shown that agrochemicals and manure runoff are the leading cause of the country’s water pollution. The government has evidently not faced up to the reality that China must import more food to reconcile rising food consumption with environmental sustainability.

Urbanization and Rural Land Reform—Grant urban residency (hukou) to 100 million rural migrants, promises of land-use rights, and hukou reform. Premier Li promised the government will focus on promoting “people-centered urbanization.”

^{**} So far, the Shanghai Free Trade Zone negative list does not open up sectors beyond what would already be allowed in China’s Foreign Investment Catalogue. For more, see the USCC’s November 2013 Trade Bulletin. http://origin.www.uscc.gov/sites/default/files/trade_bulletins/November%202013%20Trade%20Bulletin.pdf.

^{††} For example, according to the pollution monitor at the U.S. embassy in Beijing, on February 25, 2014, the concentration of PM2.5 hit 512, or “beyond index.” Feifei Shen, “China Pollution Tops Hazardous Levels Ahead of Congress,” Bloomberg, February 25, 2014. <http://www.bloomberg.com/news/2014-02-25/china-pollution-tops-hazardous-levels-ahead-of-congress-meeting.html>.

- **Expand urban hukou.** The work report said the government will work on granting urban residency permits and access to “basic urban public services” to around 100 million rural migrants currently working in the cities in the central and western regions of the country, including allowing children living with migrant workers access to urban education and expanding vocational training for migrant workers. The Ministry of Finance said in a separate report that it plans to allocate RMB 253 billion (around \$41 billion) to affordable housing, up 9 percent from 2013.
- **Infrastructure investment.** A separate report released on March 16, 2014, further fleshed out China’s ambitious urbanization agenda. The “National New-Type Urbanization Plan” expects to increase the share of China’s urban population from the current 53.7 percent to 60 percent by 2020. The plan envisions a massive investment in infrastructure, promising that by 2020 every city with more than 200,000 residents will be connected by standard rail and express roads, while every city with more than 500,000 residents will be accessed by high-speed rail.⁹ The plan also calls for the redevelopment of 4.75 million household units in shantytowns in 2014, with an expected cost of RMB 1 trillion (\$162 billion).¹⁰ According to the plan, the government expects to allow local governments to issue municipal bonds to finance urban construction.
- **Rural land use reform.** On rural land reform, Premier Li did not offer any specifics beyond reiterating promises to expand land use rights and to carry out a pilot reform project of the rural land system. This was a moderate disappointment after the Third Plenum decision created high expectations for reform; in particular, that farmers would be allowed to lease land to third parties. Under the Communist system, private ownership of land is verboten; the farmers lease land for 30-year periods but are restricted in what they can do with the land. The Third Plenum did not propose to alter the underlying system but did promise to strengthen the farmers’ property rights.

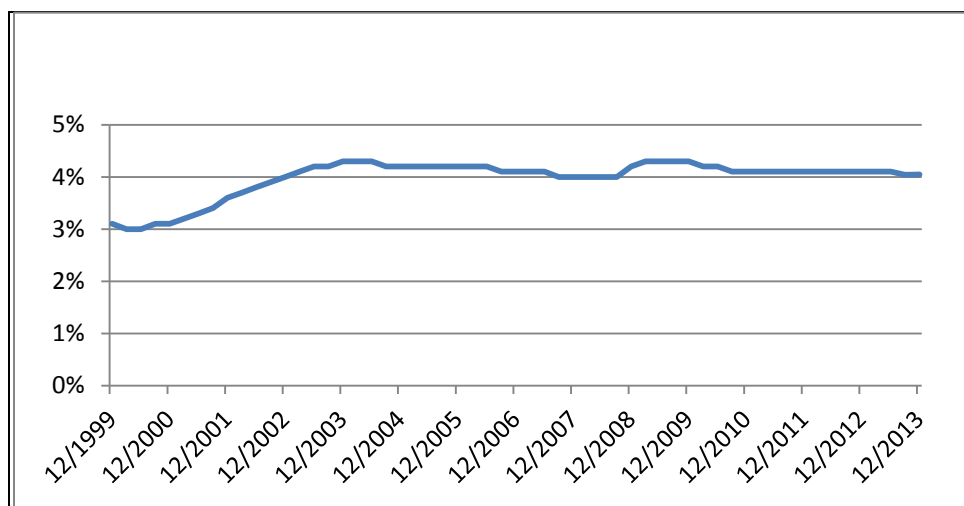
Healthcare—More user subsidies and tentative plans to reform healthcare providers. The government will take moderate steps to expand the healthcare reforms launched in 2009.

- **Expanded health insurance.** On the user side, the annual subsidy for basic medical insurance will be raised to RMB 320 (\$52) per capita and the subsidy for basic public health services to RMB 35 (\$6) per capita. These subsidies, still very low by Organization for Economic Cooperation and Development (OECD) standards, were practically nonexistent a decade ago. They will benefit the approximately 95 percent of the population insured by the government (following healthcare reforms in 2009). The government will also introduce major disease insurance to rural and nonworking urban residents nationwide, supplementing the existing “3+1” insurance scheme.^{††}
- **Hints of hospital restructuring.** On the provider side, where public hospitals constitute a powerful interest group against reform, there were fewer policy specifics. Doctors will apparently be allowed to work in more than one medical institution, a measure that so far has only been tried in pilot projects. If enacted nationwide, the restructuring would likely boost the private hospital system; one in three Chinese hospitals is private, but these providers lack good medical staff and receive less than 10 percent of patient traffic. As for restructuring public hospitals, the government stated that “trial comprehensive reform” of county-level hospitals would be broadened to cover 1,000 counties (about one-third of the total). It also cited elder care among the services open to nongovernment investors. Reports emerged just prior to the NPC meetings that a Harvard-affiliated U.S. hospital, Brigham & Women’s, is exploring the “possibility of collaborating” with Evergrande Real Estate Group Ltd., a Chinese real estate company, to build a hospital in China.¹¹ The Premier did raise the most urgent issue—adjusting prices so that hospitals do not overprescribe drugs to compensate for low medical service charges—but provided few details.

^{††} China runs a so-called “3+1” government health insurance scheme, which consists of Urban Employees’ Basic Medical Insurance (UEBMI); Urban Residents Basic Medical Insurance (URBMI); New Rural Cooperative Medical Scheme (NRCMS); and a Medicaid-like assistance program.

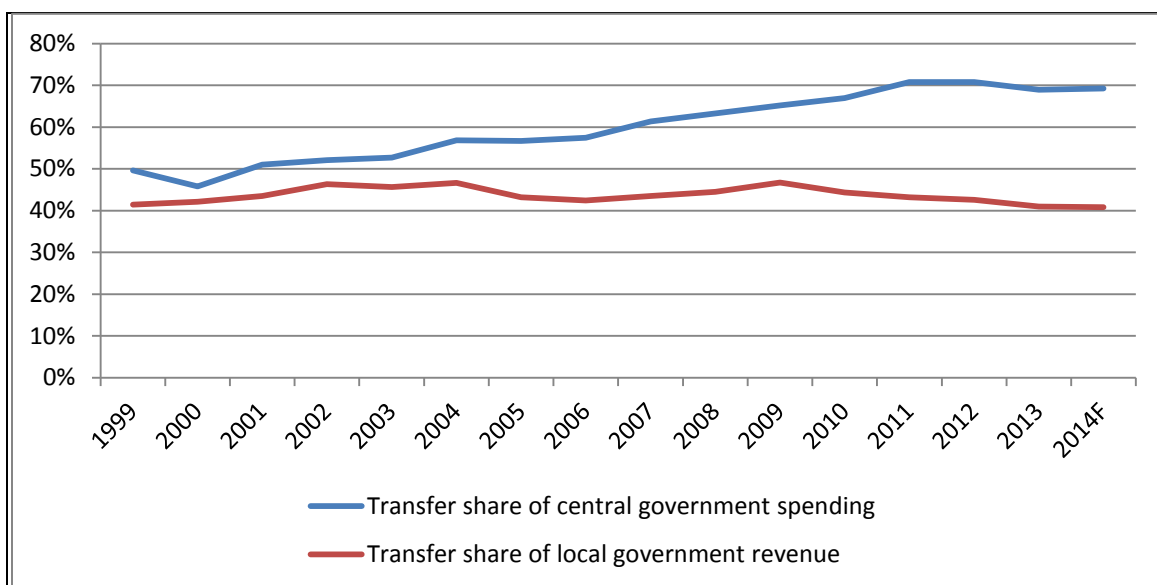
APPENDIX

*Figure 1: China's Official Registered Urban Unemployment Rate
(quarterly rate, %)*



Source: China Ministry of Human Resources and Social Security, via CEIC data.

*Figure 2: Fiscal Transfers and Tax Rebates in China,
as a Share of Central Government Spending and Local Government Revenue (incl. 2014 Projection)
(share, %)*



Sources: China Ministry of Finance, via CEIC data; China Ministry of Finance 2014 Work Report.

Figure 3.1: China's Budget Balances, Local and Central Governments (incl. 2014 Projection)
(RMB billions)

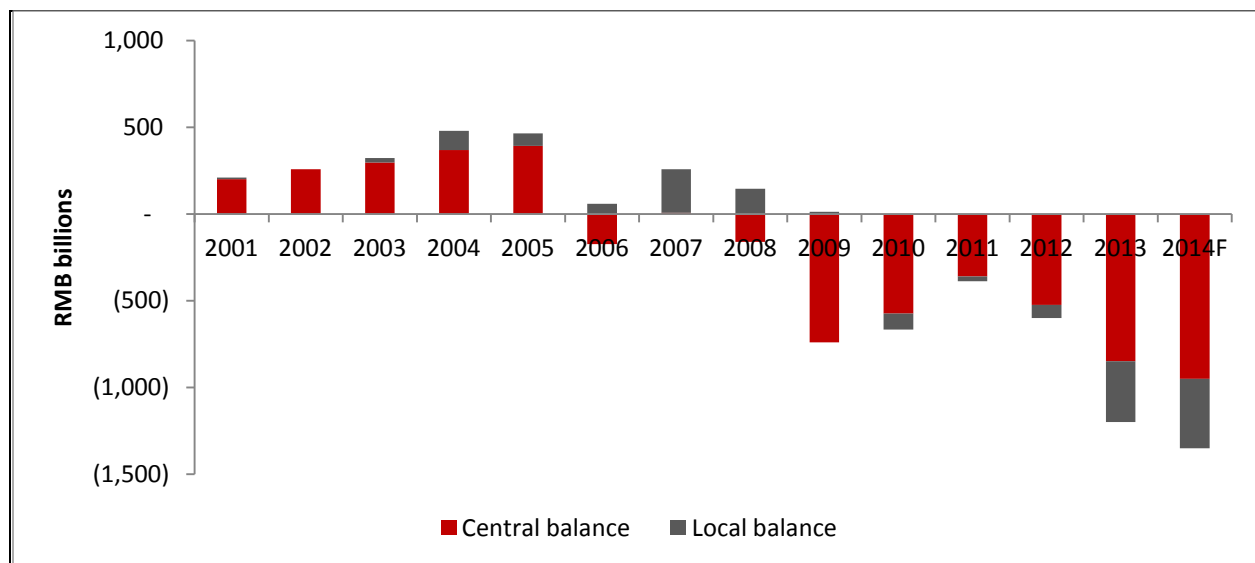
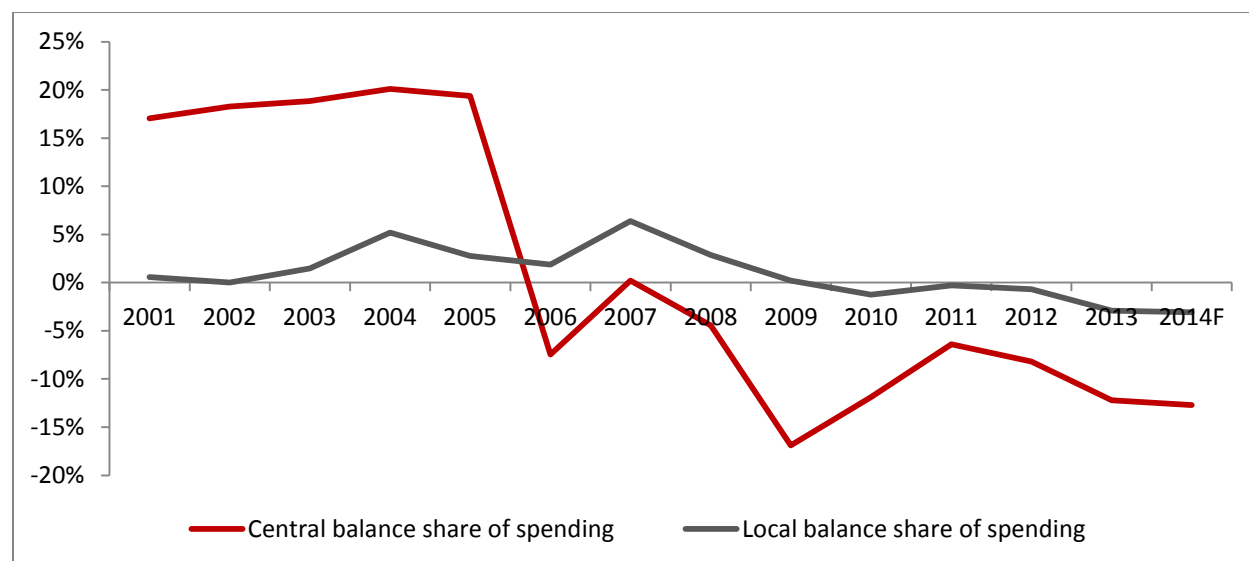


Figure 3.2: China's Budget Balances as Share of Budgetary Spending (incl. 2014 Projection)
(share, %)



Sources: China Ministry of Finance, via CEIC data; China Ministry of Finance 2014 Work Report.

Endnotes

¹ CCTV-1, "Full Text of Li Keqiang's Government Work Report at 2nd Session of 12th NPC 5 March 2014" (Beijing, China: March 5, 2014). OSC ID: CHO2014030429060374. <http://www.opensource.gov>.

² Neil Gough, "China Details Plans to Liberalize Interest Rates and Encourage Private Banks," *New York Times*, March 11, 2014.

³ CCTV-1, "Full Text of Li Keqiang's Government Work Report at 2nd Session of 12th NPC 5 March 2014" (Beijing, China: March 5, 2014). OSC ID: CHO2014030429060374. <http://www.opensource.gov>.

⁴ Paul Mozur, "China Taps Alibaba, Tencent, for Private-Bank Program," *Wall Street Journal*, March 11, 2014.

⁵ For more information, see the March 2014 edition of the USCC Trade Bulletin. <http://www.uscc.gov/trade-bulletin/march-2014-trade-bulletin>; Paul Mozur and Grace Zhu, "China's Largest Bank Declares War on Alibaba," *Wall Street Journal China Realtime*, March 26, 2014. <http://blogs.wsj.com/chinarealtime/2014/03/26/chinas-largest-bank-declares-war-on-alibaba/>; and Steven Yang and Jun Luo, "China Blocks Alibaba, Tencent Plan for Virtual Credit Cards," *Bloomberg*, March 14, 2014. <http://www.bloomberg.com/news/2014-03-14/china-said-to-block-virtual-credit-cards-from-alibaba-tencent.html>.

⁶ Matthew Miller and Charlie Zhu, "China's Sinopec Sale Points to Next Round of State Privatization," *Reuters*, March 3, 2014.

⁷ CCTV-1, "Full Text of Li Keqiang's Government Work Report at 2nd Session of 12th NPC 5 March 2014" (Beijing, China: March 5, 2014). OSC ID: CHO2014030429060374. <http://www.opensource.gov>.

⁸ CCTV-1, "Full Text of Li Keqiang's Government Work Report at 2nd Session of 12th NPC 5 March 2014" (Beijing, China: March 5, 2014). OSC ID: CHO2014030429060374. <http://www.opensource.gov>.

⁹ Jamil Anderlini, "China Reveals Blueprint to Expand Urbanization," *Financial Times*, March 17, 2014.

¹⁰ Bonnie Cao, "China to Spend More Than \$162 Billion on Shantytowns," *Bloomberg*, March 16, 2014.

¹¹ John Lauerman and Michael McDonald, "Harvard-Linked Hospital Eyes Expansion with China Billionaire," *Bloomberg*, February 17, 2014, via Factiva.