After much anticipation, the Chinese Communist Party (CCP) Politburo finally announced this week that the Third Plenum of the 18th Central Committee will take place November 9–12. Top Politburo Standing Committee (PBSC) members in recent days have been busily raising expectations over the presumptive launch of a new wave of economic experimentation at the plenum. President Xi Jinping has been touting “a master plan for reform,” while fellow PBSC member Yu Zhengsheng upped the ante by suggesting that “The depth and strength of the reforms will be unprecedented and will promote profound changes in every area of the economy and society.”

So this is a done deal, right? Well, not exactly. The State Council’s official think tank, the Development Research Center (DRC), earlier this month published a report, informally referred to as the “383 plan,” which lays out a fairly detailed blueprint for reform. The report garnered widespread attention for both its relatively bold policy prescriptions and its unique provenance. Its principal drafters were Liu He, President Xi’s trusted muse on economic reform, and the former secretary to Zhu Rongji. As premier in the late 1990s, Zhu oversaw the last great burst of reform activism, and his acolytes generally are credited with being the torchbearers for his reformist legacy going forward.

As the report gained interest, however, it sparked a substantial backlash from others, including a few quite prominent Chinese economic thinkers, who emphasized that the 383 plan was just one of several proposals being considered by the Politburo for possible implementation at the plenum. The brouhaha was eerily reminiscent of the domestic controversy over the DRC’s last substantial treatise on reform, the so-called China 2030 Report, which also was crafted by Liu He in conjunction with the World Bank. In that instance, it took many months before a Chinese-language version of the report was available for...
wide circulation in the country, highlighting the substantial internal opposition to many of its conclusions and recommendations.

So it is abundantly clear that not every constituency in the CCP hierarchy is necessarily on board with the reform push, even this close in to the plenum. This should come as no surprise given that several of the reform proposals under consideration threaten to undercut the privileges enjoyed by the regime’s many powerful vested interests or to substantially impinge upon their bureaucratic turf. Against this backdrop, it is equally unsurprising that skepticism has become the dominant theme among many China watchers. Unable to subdue the pushback from the recalcitrant interest groups, the leadership will end up watering down the reforms to achieve the all-important consensus that maintains stability within the Party elite, or so the thinking goes.

Of course, such assessments are the conventional wisdom for a reason—they are usually right. Still, looking at the issue from a different angle may prove to have more explanatory power in the long run. Perhaps a more consequential line of inquiry is to examine whether the CCP truly can afford to avoid some sort of bold reform gestures, given that the current economic model’s gears appear to be grinding, and the economy continues to be buffeted by substantial headwinds both domestically and abroad. In other words, is there an unseen risk in sticking to the policy incrementalism that has allowed the CCP to muddle through—and even to flourish—so successfully over the last decade and more? If so, what possible signposts might we identify to warn of such danger?

China’s credit explosion, and the leadership’s seeming game plan for addressing it, may offer some clues. Put crudely, China has a debt problem. Of the two chief contributors to China’s mounting debt woes—unrestrained local government spending and the misallocation of resources to underperforming state-owned enterprises (SOEs)—Xi and the rest of the senior leadership clearly have chosen to focus their energies on dealing with the localities. On the one hand, this is because the leadership understands that the problem with local debt is even worse than estimated, making it a bigger near-term threat to China’s financial stability than the corporate debt of the SOEs.

Nevertheless, the essence of the leadership’s calculus is political. Xi is keen to recentralize authority and decisionmaking in response to the
unintended consequences of 20 years of devolving power, which has resulted in local fiefdoms that can often disregard Beijing’s will. Moreover, the localities are simply an easier target than the influential vested interests and their allies in the state machinery that are shielding the SOEs.

Adding to the localities’ potential woes, the leadership is considering fiscal and tax reforms for the plenum that would further squeeze local government finances. Under one proposal, the localities would be allowed to issue bonds in exchange for eliminating their highly opaque local financing vehicles, but these bonds would be subject to central government oversight, depriving the localities of a key source of off-budget financing.

The center also is deliberating experimental changes to rural land policies that eventually would allow farmers to sell rural construction land directly to the urban market without going through an expropriation process. Under current regulations, such transactions cannot take place until the local government requisitions the land, allowing it to pocket the difference between the sale price to the developer and the paltry compensation offered to farmers by the local officials. Localities earn an average of half of their fiscal revenue from land sales, leaving a tremendous hole if these policies are implemented. Given that most observers are ruling out any substantial reallocation of overall revenue to the localities, it is possible they could be left in the fiscal lurch for some time as Beijing put its ducks in a row for more sweeping fiscal reform.

The curious rollout of the Shanghai Free Trade Zone (SHFTZ) offers another glimpse into the potential pitfalls of pursuing stepwise reform. Typically, one would expect the plenum to announce some broad principles and guidelines, to be followed by the launch of a test bed, like the SHFTZ, to serve as the implementation platform for translating those generalities into concrete policy experiments. The leadership therefore appeared to put the cart before the horse by launching the zone more than a month before the plenum is set to convene. This has generated much speculation that the leadership has already conceded defeat on making any major breakthroughs at the plenum, defaulting instead to the timeworn practice of confining economic experimentation to a pilot project.
Although such conclusions undoubtedly reflect an injudicious rush to judgment, the leadership is potentially playing with fire with the SHFTZ. To give but one example, the zone’s promise to gradually liberalize deposit rates to allow them to be set by the market is sure to stir resentments among investors unable to participate in the zone. In fact, there are signs the reformist coalition at the center may welcome such discontent as a means to leverage those who oppose expanding such reforms nationwide. If such tactics are unsuccessful, however, and the center is forced to stall or claw back on the policy in the SHFTZ, the leadership’s credibility could be significantly damaged.

Of course, we can safely assume the leadership is fully cognizant of the possible consequences associated with either local fiscal reforms or the various programs associated with the SHFTZ and has thought through how best to proceed. Still, one does not have to look too hard in recent Chinese history to find instances where sticking to “the reform of the possible” produced unintended consequences that required far more draconian measures to contain the mess. Recognizing that reform in China is a complex minuet that often plays out over decades, it is only prudent to keep our expectations for the plenum modest. But the new leadership team already has clearly demonstrated that it is very different than the previous administration. With that in mind, perhaps Xi and his colleagues will find a way to buck history and surprise us on the upside.

**FREEMAN CHAIR IN CHINA STUDIES**

Christopher K. Johnson, Senior Adviser and Chairholder  
Bonnie S. Glaser, Senior Adviser for Asia  
Jacqueline Vitello, Research Associate and Program Coordinator  
Nicole White, Research Assistant and Program Coordinator  
Chen-Kung Peng, Liangxiang Jin, Hongtie Zhang, Visiting Fellows  
Minjun Chen, Denise Der, Chris Mclachlan, Deep Pal, Research Interns

*The Freeman Report is an electronic newsletter produced by the Freeman Chair in China Studies at the Center for Strategic and International Studies (CSIS), a private, tax-exempt institution focusing on international public policy issues. Its research is nonpartisan and nonproprietary. CSIS does not take specific policy positions; accordingly, all views, positions, and conclusions expressed in this publication should be understood to be those of the author(s).*  
© 2013 by the Center for Strategic and International Studies. All rights reserved.