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Overhauling the bureaucracy is the first test of the new leadership's reform efforts

There are many analogies for how China's reform process works; we prefer the sailboat

China Policy Watch: Government Restructuring

Reform Sails Against The Wind

China's ship of state now has a new captain and first mate. Their first mission is to rethink and restructure a government that has enormous influence over every aspect of the economy, and yet has great difficulty in meeting its promises to the public. So what kind of helmsmen will they prove to be?

Your answer to these questions depends on what kind of ship you think China is. Some observers believe that as long as the leadership calls for change, change will follow because of the country's authoritarian system. For them, the best metaphor for China may be an ocean liner, whose powerful engines allow it to cut through wind and weather under the clear-eyed guidance of its captain. Other, more pessimistic observers see a divided leadership and powerful interest groups that have not reached a fundamental consensus on reform. The result is a chaotic swinging between liberalization and reassertion of state control; like a ferry crossing between two sides of a river, there is movement but no forward progress. Others argue that even the appearance of movement is an illusion, and that China's leadership is complacent and enmeshed in a corrupt system. As they sit back and enjoy the material benefits of past reforms, they look like the guests on a riverboat casino anchored next to shore.

Choose your boat: visions of how China's reforms will proceed

		What is the top leadership's judgment?	
		Reform is urgent	Reform is unnecessary
What is the policymaking process like?	Unified	**Ocean Liner** Reformist leaders hold to a consistent course, and can push through substantial changes	**Riverboat Casino** A complacent leadership focuses on maintaining the status quo and living off past reforms
	Fragmented	**Sailboat** Reformist leaders face opposition and must constantly change course to move forward	**Ferryboat** A divided leadership swings between policy priorities but makes no forward progress

GK Dragonomics metaphors

To us, China seems more like a sailboat, which must tack back and forth as the wind changes, but still gets to its destination. Top leaders Xi Jinping and Li Keqiang do appear to believe that fundamental changes are needed to avoid a future economic crisis, but they face opposition from some of their colleagues, local governments, state-owned enterprises and other entrenched interests. As a result, the introduction of new policies is typically gradual or experimental. Compromises, compensation for opponents, and occasional retrenchment are all part of the game. This pattern can be seen in how the new leadership moved to put their stamp on the personnel and organization of China's government, a traditional first step for a new administration taking office. A new direction has clearly been set, but the sailboat still has a ways to go to reach its goal.

Laying down the keel

The latest wave of bureaucratic restructuring faces a familiar set of issues

Since the start of the reform era in 1978, there have been several waves of bureaucratic reform and restructuring, and each has struggled with four core issues. First and most obvious has been the effort to reduce the number of agencies and officials, particularly at the central government level. The number of central ministries has declined from 52 in 1981 to 25 today, and the overall count of central agencies has shrunk from 100 to 62 over the same period. Similarly, the number of central government officials has been cut by over 40%, from around 500,000 to under 300,000. China's government overall is still massive, but that is because the country is massive. There are more than 10 million civil servants, but 98% of them serve at the local level.

The central government has already been downsized and simplified, and the pace of cuts has slowed

Beijing's incredible shrinking government

Number of central government bodies

Year	Ministries	Total agencies
1981	52	100
1982	44	72
1988	41	83
1993	40	74
1998	29	71
2003	28	62
2008	27	62
2013	25	62

State Council, GK Dragonomics research

A bigger challenge is changing the role and function of government

The second and greater challenge has been to shift the government from being the director of a planned economy to the regulator of a market economy. Mandatory planning and output quotas have indeed given way to softer development objectives and the use of a wide variety of regulatory, fiscal and financial tools to guide economic activity. Yet discretionary administrative intervention, legal or otherwise, is still omnipresent in China. Steps away from direct intervention are often fleeting.

This is related to the third area of difficulty, to separate the regulators from the regulated—in Chinese political parlance, "separating government and enterprises." State-owned enterprises were spun out of the government in the 1980s, and many were closed or further overhauled in the 1990s. While their formal ties to the government have diminished, their continued prominence in the economy and their links to local and central authorities means the line between state and state-owned firm often remains blurry in practice. This causes problems for private and foreign firms.

The fourth and least successful area of change has been developing the government's legal authority independent from the Communist Party's political authority, what is known as "separating government and the Party." Though a catchphrase for political reformers for decades that has been regularly invoked in speeches, the reality has been continued dominance of the Party system over the formal levers of governance. Because of this bias, China's occasional attempts to move toward an "independent commission" approach to regulation, in which civil servants are protected from direct political intervention, have failed.

China needs a more flexible and responsive government to handle the shift away from investment-driven growth

Making progress in all four of these areas is necessary to cope with the next stage of China's economic development. China's top-down system had some advantages in pursuing an investment-driven growth model, but as its priorities shift to sustained technological innovation, more productive services and a consumer-driven economy, the government needs to be more nimble and responsive. Over the past decade, the Hu-Wen administration made moderate progress on cutting the size and changing the function of government, but their support for state-owned enterprises weakened market competition. And the ties between the Party and government only tightened on their watch.

Setting a new course

As the new leaders assumed their formal government roles in March, it became clear that Xi Jinping will keep his attention on the big picture—setting aspirational goals to achieve the "China Dream"—while Li Keqiang will be responsible for the heavy lifting of actual governance. And while Li did not drop any revolutionary bombshells at the annual session of the National People's Congress, he nonetheless established an approach distinct from his predecessor. One line from his press conference indeed may come back to haunt him: "Talking the talk is not as good as walking the walk. We need to pursue market-oriented reforms."

Xi and Li's bureaucratic changes highlight their policy priorities for the future

Xi and Li made six substantive changes to the central government's organization chart—many fewer than in the more radical proposals floating around Beijing prior to the NPC meeting—but each is linked to broader areas of future reform. For instance, while family-planning laws remain in force, the National Population and Family Commission ended its existence as an independent government body, being subsumed under an enlarged and renamed health ministry. This move signals that preparations have already begun for the end of the one-child policy.

The folding of the ineffective State Electricity Regulatory Commission into a strengthened National Energy Administration is also a sign of the quickening momentum for energy price reform (see Powering Up Price Reform). Within a week of the NPC session, prices for diesel and gasoline were further liberalized. This followed the abolition of coal and upstream power price controls in December 2012, and moves to raise natural gas prices in several large eastern cities in February. Similarly, the expansion and strengthening the China Food and Drug Administration, which was given more authority over food safety, should be followed by better food regulation and liberalization of prices for drug and health care services.

The most high-profile change was the elimination of the scandal-plagued Ministry of Railways, which could be the first step in reducing the state's monopoly of the rail system. Responsibility for running the massive national network has passed to the stand-alone China Railway Corp., with the old ministry's regulatory functions absorbed into the Ministry of Transport. This brings the rail sector, a haven of central planning, into line with other industries once run directly by the government, and will make it easier to deregulate.

State-owned enterprises retain close links with government policymakers

These changes at least begin to make further progress on two of the four priorities of government restructuring: further downsizing of the bureaucracy, and separation of government and enterprises. But the cuts to the number of agencies were certainly not dramatic, and will result in little actual decrease in the government payroll. And while the excessively powerful Ministry of Railways was finally cut down to size, there are plenty of signs that the tight relationship between the government and SOEs is not weakening. Exhibit A here is the appointment of China National Petroleum Corp. president Jiang Jiemin as new head of the State-owned Assets Supervision and Administration Commission (Sasac), which oversees the largest centrally-controlled SOEs.

A new initiative to cut red tape and administrative approvals could have a big impact

Perhaps the most important area of progress is the renewed attention that will be given to stream-lining the thicket of administrative interventions in the economy—essential if the government is indeed going to become a regulator rather than a planner. Li stressed the general principle that government authority to approve projects should be reduced and that wherever possible authority for such approvals should be moved to local governments. He set a specific goal of eliminating one-third of the 1,700 types of administrative approvals required by central government agencies, and further targets have been set in a few key areas: 1) reducing red tape for companies and decentralizing the approval process for business activities; 2) reducing inter-regional barriers to trade and investment and unifying China's national economy; 3) creating a real-name systems for financial accounts and developing a comprehensive credit rating system; and 4) making China's industry associations fully autonomous from government control and allowing competition among associations. One caveat to this laudable trend: there is little sign that the National Development and Reform Commission (NDRC), which has huge authority to approve or block major investment projects, is getting fundamentally weaker.

Choosing the crew

Personnel changes were not radical, but put in place a strong group of economic reformers

In selecting the people to implement their agenda, Xi and Li are also tacking back and forth rather than driving full speed ahead on reform. While there were many notable changes in personnel, there was not a complete turnover: 16 of the 25 ministries kept their current ministers in place. But the figures in charge of economic and financial policy together make up a strong pro-reform group.

Despite reaching retirement age for ministers, Zhou Xiaochuan was kept on as the central bank governor using a little-known rule that lets vice-chairmen of the Chinese People's Political Consultative Conference remain in all of their offices until age 70. Guo Shuqing, who pushed through dozens of policy changes in his 17 months heading the China Securities Regulatory Commission, has somewhat oddly been named acting governor of Shandong. But he is a good candidate to eventually return to the central government in Beijing, possibly to replace Zhou when he retires. Guo's replacement, Xiao Gang, who moves over from Bank of China, has run the bank well and also joined in the public policy debate over the shadow banking system. New finance minister Lou Jiwei, who moves over from heading China's largest sovereign wealth fund, is part of the same cohort of pro-reform officials with financial backgrounds. At the Ministry of Commerce, the unpopular Chen Deming was replaced by Gao Hucheng, who is moving up from his previous job as vice-minister and chief trade negotiator. His promotion could signal a more professional and proactive approach to trade negotiations, where China is developing alternatives to US initiatives for "high-standard" regional trade pacts in the Asia-Pacific and Europe.

Scholars who have drafted blueprints for reform are getting power to implement their proposals

But perhaps the most significant indicator of a greater commitment to reform is the appointment of Liu He as an NDRC vice chairman and director of the office of the Party's Central Leading Group on Financial and Economic Affairs. The unusual joint appointment puts him in position both to set the agenda for economic policy discussions among the senior officials on the leading group and to execute policy through the NDRC. Liu had been running the State Council's in-house think tank, the Development Research Center, and was former President Hu Jintao's closest economic advisor. Liu has been a leading voice for economic reform, and played a role in the joint DRC-World Bank *China 2030* report, which laid out a strong but pragmatic agenda for economic liberalization, technological upgrading and environmental improvements.

Looking beyond the horizon

The focus of China's new leadership is now turning from the internal functioning of the government to the execution of policy. We will be able to tell how much progress is being made by watching three sets of developments. The first is whether continued progress is made in liberalizing state-controlled prices: there has already been notable change in energy, but regulated prices for drugs and health services, and for bank interest rates, are also overdue for change. The second is the content of the new government's promised plan on urbanization. If urbanization is to effectively drive consumer spending and service-sector development, there needs to be change in the household registration (*hukou*) system. The third will be the full articulation of an economic reform agenda that is expected at the Communist Party's fall plenum. The same point on the Party political calendar was used by Deng Xiaoping in 1978 and Jiang Zemin in 1993 to launch their own programs of economic reform, so hopes are already high. The upcoming plenum thus marks the best opportunity for Xi Jinping to explain how he wants to steer China's economic reforms. If he can keep a firm hand on the rudder, by the time the next Party Congress convenes in 2017, China will have arrived at a substantially different place than it is in today.

The leadership still needs to deliver on price reform, urbanization policy and a more coherent overall strategy