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China Reforms 2.0: What's Next? The "Rule by Law"!

China has reached the limits of its current “business model” and must reform in order to continue to grow in ways that are sustainable in the long term. A change of model, as business leaders know, necessitates far reaching changes in an organization. In China’s case, this calls for not only decisive overhauls of economic policy but also fundamental changes in the leadership culture. Considering the size of the country and the importance of the vested interests, particularly in the state sector, the efforts underway to carry out the new reforms are assuredly as challenging and intense as the opening up of China that Deng Xiaoping launched 35 years ago, with the success that we all witnessed.

In a nutshell, **China's current growth model** based on investments channeled through state-owned banks and companies (sometimes referred to as "State Capitalism") **has run its course**. It cannot go on without driving the state's debt beyond acceptable levels. Besides, state-owned companies have become both centers of power and of corruption, allowing them to challenge government policy to pursue their interests, without care for the environment and the effect of pollution on people's health.

Without a complete change of China's current development model, the country would most certainly come to a period of severe disaffection of its population and very slow (or no) growth.

Rumor has it that 225'000 officials have been or will be arrested in China by the current anti-corruption drive and another 18'000 who are currently abroad are being actively pursued. The total amounts embezzled are said to have reached USD 2-3 trillion, about 70% of which are expected to be recovered (adding high profitability to a good policy move)!

In addition, investments have become increasingly prominent as a share of China’s GDP, resulting in a galloping government debt, which, if unchecked, could be the cause for a financial crisis. Needless to say, such developments have alienated a sizeable portion of the population which cares about its health as much as it cares about its material wealth.

Sluggish growth (or a financial crisis which would ultimately turn into a recession) is an unacceptable outcome for the population. Indeed, such a situation would erode the unspoken contract that binds the Chinese government to its people, whereby the leadership continuously provides improved living conditions while the population accepts not to be directly involved in the political decision-making process.

The new sets of reforms underway, therefore, are not nice to have: they **are an absolute necessity** for both the country to continue its development and for the leadership to maintain its legitimacy and, by consequence, its mandate to govern.

(See our previous analysis for a detailed review: 2014, China at a Turning Point.)

What is to be done?

The obvious solution is to turn China's growth model away from its current reliance on investment and towards greater domestic consumption and private investments. This means encouraging citizens to spend more of their money on setting up businesses and improving their lives, instead of saving and lending their savings to the government, who in turns spends it on infrastructure projects or lends it further to state-owned companies.

But increasing private consumption and investments is only part of the solution to achieve sustainable growth. Since the working population (the number of people generating GDP) is reaching a plateau, productivity needs to improve to maintain a growing economy. Indeed, without more people joining the workforce, each person working will need to generate more economic output to deliver overall growth.

And since state-run companies are clearly less profitable and efficient than private ones, **encouraging the private sector** and **providing opportunities to entrepreneurs** is the obvious answer to, all at once, **increasing productivity and private consumption** as well as **keeping the increasing government debt under control**.

Corruption must be stopped

The solution is evident, but its implementation goes against the vested interest of the state-owned sector, the politicians who control it, and their entourages who derive gains from it.

A telling example of the pre-eminence of SOEs' vested interest is the fuel and oil industry. In 2009 the State Council (China's Cabinet) issued the China III Diesel Standards, which were simply ignored by the (state-owned) oil companies[1] in order to maintain their profits. These SOEs would not have been able to do so without the patronage of high level officials such as Zhou Yongkang, a former Standing Member of the Politburo and a former Head of China National Petroleum Corporation.

[1] The situation is detailed in New York Times article "As Pollution Worsens in China, Solutions Succumb to Infighting", of March 21, 2013

Clearly, to ensure long-term sustainable growth and eventually **nothing less than the future of China**, there can be no alternative other than reducing the influence of the state sector and therefore the power of those who benefit from it. Government clampdown on graft, bribery, and embezzlement is an absolute necessity for a number of reasons, not least of which is to prevent large State Owned Enterprises (SOEs) from operating under de facto immunity from government prescribed policies.

It is no wonder, then, that China's new President warned in his acceptance speech that corruption had become a threat to the Communist Party and its leadership of the country, so much so that he made fighting corruption his first priority.

From then on, a key question that would decide the country's future was whether the new government could be strong and determined enough to eradicate the politicians' traffic of influence and rein in the state sector.

Fortunately enough, **events of the past year have provided room for quite some optimism**.

A clear indication of both the new government's determination and the support that it commands is the decision to arrest top level officials (including the Army's No 2) and to investigate the former security Czar (Zhou Yongkang) for "serious disciplinary violations." Remarkably**, it is the first time in the history of the People's Republic of China that a former Standing Member of the Politburo is investigated**. Though the move is certainly part of power-consolidation, it is also to show that in today's China, no one is untouchable. What's more, it warns officials that no former leader will be strong enough to protect allies and former subordinates against their unethical behavior. As a result, any official that wants to feel safe will apply policy ethically.

This in itself is a strong indication that corruption at high levels will be considerably reduced (if not eradicated) in the short term. And by ensuring discipline among officials, it is empowering the Chinese administration and fulfilling the first necessary step for the success of the much needed reforms.

Last but not least, these effective moves to clean the government have an important side-effect: ordinary people see their lives improving immediately. As a New York Times commentator reports, officials do not dare require semi-official fees (in fact often hidden bribes) anymore. She gives the example (among others) of the enrollment of her son, six years ago, in a local school where a mandatory "donation" of RMB 20'000 was requested. This year, when enrolling her daughter in the same school, no such fee was asked for[2].

What is next? "Rule by Law" to regulate government and free the economy

[2] "In Fighting Tigers, Xi Inspires the Masses", By Didi Kirsten Tatlow, New York Times 24 September 2014

It is also important to note that Zhou Yongkang was lastly in charge of China's internal security which includes the police and the judiciary, a department endowed with a bigger budget than China's military. The internal security system's first mission is to maintain social stability, the overarching priority of China's government. Fairness and equality of economic opportunity came clearly second in terms of objectives of the legal system.

Yet, once unethical civil servants are out of the way, reforming the legal system is a natural next step. A well-performing and ethical judiciary is needed, first of all, to ensure that corrupt practices do not resurface. But just as importantly, it is the essential tool to bring about equal economic opportunities for companies small and large, private or state-owned. This economic fairness is also the best instrument to motivate the private sector to invest, to generate confidence and galvanize individual consumption.

It is therefore no surprise that the main themes of the coming October plenum of the Communist Party have been announced to be "**Rule by Law**" (the officially sanctioned term for the role of the law in China's constitution) and the **economy.**

Limiting the arbitrary power of the State

A key pillar of the reform agenda is therefore the strengthening of the legal system in favor of the citizens and entrepreneurs by fostering **greater transparency**, more **judicial independence,** while simultaneously **professionalizing the judicial decision-making processes**.

Among other provisions, specialized intellectual property rights courts will be established and officials have been instructed to provide expanded government information to the public, particularly about the way local governments use their funds. Furthermore, a transparency mechanism is planned that will require for the Chinese government to disclose all of its administrative approval requirements, starting first with those at the central government level. Under this arrangement, government agencies will no longer be allowed to interfere in the approval of items not included in their own registers. For the sake of transparency, these same agencies will additionally have to publish their administrative approvals items on their official websites.

New decisions and opinions[3] are bringing about some fundamental changes on the way the legal system works. Amongst these is a clear emphasis on enforcing greater judicial accountability for judges, prosecutors and police; sheltering judgments and decisions from public opinion and establishing a greater division of powers between the judiciary and law enforcement bodies.

[3] "On Earnest Prevention of Miscarriages of Justice", later complemented by the supplementary opinion of the Supreme People's Court on "Completing Systems of Prevention of Wrongful Cases".

Amendment to the Company Law

On the economic side, to stimulate private investments and entrepreneurship, China's National People's Congress adopted the "Amendment to the Company Law of People's Republic of China", which has lowered establishment requirements and reformed capital registration regime for new companies. As of 1 March 2014, the most significant changes are as follows:

- The change from the system based on paid-in registered capital to one based on subscribed registered capital is expected to have the greatest impact. By allowing investors to contribute capital over a much longer period, companies are given much more flexibility in developing their operations.

- The minimum registration capital of RMB 30,000 for limited liability companies will be cancelled, as well as the RMB100,000 minimum for single shareholder companies and the RMB5 million minimum for joint stock companies. Theoretically, investors will be able to establish a company with a registered capital of one RMB. Further to this point, the amendment cancels the requirement that at least 30 percent of the registered capital contribution be made in cash.

- In addition, companies are no longer required to go through a yearly inspection. Instead, they will provide annual reports, part of which will be **publically disclosed via an online government platform**.

Foreign-invested companies in China will see the same easing of company registration requirements provided by the latest amendment to the company law.

This is widely expected to benefit entrepreneurs and businesses by removing government red-tape all the while decreasing the time necessary for businesses to have projects approved by the government.

The Legal System's New Role

The set of legal changes underway illustrates the resolve by the Chinese leadership to regulate the way the government operates, while at the same time building a society and economy where the state plays a regulatory, rather than a direct interventionist role.

Ultimately, this is intended to create a much more level playing-field to support the development of private businesses in China as along with generating an environment perceived to be fair by common citizens.

In so doing, the Chinese government clearly intends to put the legal system to the service of China's development while keeping it under government control. This is the Chinese constitution's "**Rule by Law**" concept. While the judiciary is not made independent as it is in the western principle of Rule of Law. It does however, clearly go towards establishing a fair and pro-business society.

This was most aptly summarized by the Prime Minister Li Keqiang, when he declared that: **"Whatever the law does not prohibit can be done as far as the market is concerned, while whatever the government does must be authorized by law."**[4]

While the new set of reforms clearly intends to instill dynamism in the private domestic economy rather than encourage foreign investment (the objective of the first set of reforms 30 years ago), foreign companies will still benefit. On one hand additional sectors are being opened to foreign investments, but most important is the more level playing field that is undoubtedly being built.

This is good news for all those involved in China and for the world in general: should the new reforms succeed as it seems they will, we can expect growing **China-size economic opportunities** and a **much more favorable environment for private and smaller size enterprises.**

For more information, should you be interested in **how Swiss, EU, US and Chinese companies see the future of their business in China**, do not hesitate to check our 2014 China Business Survey conducted in cooperation with CEIBS

[4] anti-corruption speech delivered on 11 February 2014