# China Briefing

## Uncommon prosperity? What China's new development model means for investors


## Executive summary

- *China's economic focus has now changed: rather than lifting citizens from abject poverty, the goal now is to have a more fair distribution of income. They have called this a new economic development model; expect to hear a lot of the slogan "common prosperity" for the next decade.*
- *The Chinese government will lean heavily on private companies and especially the tech sector to both fund and deliver on their promise.*
- *This is a rare period of Chinese policy where things are not set. Different groups are jockeying for position. Many things have been left unclear. Whoever sets the rules now will keep others playing their game.*
- *This is a good thing for foreign investors, should they be allowed to deploy their capital, as it will standardise and clarify a number of loopholes. But it will be bad for firms wanting to list in the US, and may hurt consumer sentiment.*

China's leader Xi Jinping recently declared that the nation would "promote common prosperity". This Briefing attempts to decode this for investors by identifying common and related themes promoted in Xi's previous speeches through machine reading. We use that information to predict where Xi might be leading China with this concept.

Why does this relate to investment? Because it appears that common prosperity is the umbrella term for all Chinese economic development. Any plan coming out of China will need to reference it. That will greatly drive economic outcomes and directions for the next decade, and hence investment decisions.

As Xi himself introduced it:

"(Common prosperity) is an essential requirement of socialism and an important feature of Chinese-style modernisation. It is necessary to adhere to our people-centred development ideology and promote common prosperity amid high-quality development. Should it do this, common prosperity would promote social justice, the all-around development of humankind, and enable the entire people to stride firmly forward towards the goal of common prosperity."

In other words, should we fix this, not only will we solve social justice but also economic development and foreign relations.

So, what is common prosperity? Basically, it is re-engineering China's income distribution.

As Xi put it:

"Achieving common prosperity is not only an economic issue, but also a major political issue related to the Party's governing basis. We must not allow the gap between the rich and the poor to grow wider, the poor getting poorer and the rich getting richer, and an insurmountable gap between the rich and the poor must not appear."

This tone can be read in two ways. One is that China is deeply worried about inequality, and wants to find a new way to address it. (That said, it is important to note, this is not a defensive stance, but rather an acknowledgment of success. As Xi put it, "After eight years of hard work, China's mission of poverty alleviation successfully lifted some 100 million people out of poverty, building a solid foundation for moving to the next target — realising common prosperity.")

Another interpretation is that it is attacking capitalism itself, and that "common prosperity" is really a return to removing private capital from China's economy. Much of the current media analysis is along these lines.

For investors, the difference is mission critical. But lifting the strands from Chinese ideological and regulatory thought can be rather difficult.

In this piece we will try and highlight what we think foreign investors need to know, in order to see if there may be a common path to prosperity, a road that doesn't involve China walking alone.

It is easy to look at giant political slogans like "common prosperity" and see it as an all-conquering, unstoppable juggernaut. That is not the case. Rather, concepts are built layer-by-layer, one specification at a time. Common prosperity is an ideological concept, a call for various parts of the system to try and respond and specify what they think it means. This specification will ultimately create the final policy for common prosperity.

Elements of common prosperity will be well-suited for foreign capital. The game now is to see when those elements might be winning, and deploy accordingly.

## What is common prosperity?

In these early days following on the heels of common prosperity being announced, the first thing to do is to go back and look at previous speeches.

There appear two themes in particular. First, common prosperity must have a popular touch. At a Politburo meeting (China's real cabinet, a group of 25 that meets roughly monthly), they said that people needed to "really feel that common prosperity is not just a slogan, but a visible, touchable, real, and perceptible fact." In other words, the way we will measure success at common prosperity is to show various actions that can be attributed to it.

The second theme is that it must be visibly tough on the wealthy. Xi says that the government "must strengthen the regulation and adjustment of high incomes...reasonably adjust excessive incomes, and encourage high-income earners and enterprises to give back more to society."

The concrete details of common prosperity are sharper. The fine print calls it "an olive-shaped [income] distribution structure with a large middle and small ends". Note that this is not egalitarianism. It is not a flat structure with a single wage. It is not moving away from the idea that some might get rich first. Rather, it is a planned redistribution of income. For investors, this is important: it means that retaining wealth is possible, but that there will be more rules involved.

Some questions remain as to why this is happening now. Inequality has been an enormous issue throughout modern China, and one perhaps most pithily summarised in former leader Deng Xiaoping's quote about money flooding through elite politics: "too much and we lose the people, too little and we lose the Party".

In popular opinion, former leader Hu Jintao's post Global Financial Crisis financial stimulus package in 2009 also led to floods of cash washing away many morals. Xi Jinping himself went after inequality in his first administration through high-profile and rigorous anti-corruption campaigns.

But inequality is a structural issue more than an individual bad apple issue. Chinese economists and development specialists themselves discuss these factors as being:

**What led to common prosperity**

1. Systemic restrictions on the factor market — land, labour, etc. — have led to price distortion for production factors.
2. The development strategy that favoured China's eastern seaboard provinces at the beginning of China's reform and opening-up meant that capital and growth were unequally distributed.
3. The GDP growth targets and tax-sharing system compelled local authorities to prioritise economic growth over people's livelihood.
4. A flawed tax policy limited the effect of income redistribution.
5. An imperfect financial market failed to provide different income groups with equal access to credit.

In some ways, major foreign banks agree with them. The wealth Gini coefficient, a measure of inequality, is in the 70s according to a recent report by Credit Suisse whereas the World Bank says that the income Gini coefficient is in the high 40s; both are causes for concern. There are also some distortions in the tax system that could do with being fixed. Property goes untaxed altogether, apart from timid experiments in two cities, which helps explain why the wealthy buy second, third, and fourth homes as investments — and leave many of them empty.

So Xi's common prosperity push is clearly based on solid ground, in that inequality is of considerable concern. What we don't know is whether he is acting because of this being long overdue, or if this is because he wants a new model because of other reasons. The worry is that he may go too far. We turn, then, to looking at what is currently involved in common prosperity.

## How will this work?

As with most long-term goals and slogans, the better question may be what will not be involved in common prosperity. Slogans usually get

attached to everything and then the rest is backfilled in order to make sure that it is a "common prosperity" idea rather than just a normal policy.

That said, there appear a few things that are posited as unique. The first of these is the so-called "three distributions". This was defined as the market being the first means of distribution, the government being the second, and the third being society itself through greater philanthropy.

Let us address these one by one. The market as the "means of distribution" will be attacked through "strengthening anti-monopoly regulation and promoting fair competition". Xi's speech argues, somewhat wordily, that "anti-monopoly regulations and policies promoting fair competition is an intrinsic requirement for improving the socialist market economic system."

What this really means is that SAMR, the Swiss Army knife of Chinese regulation, will continue to be Xi's shock troops to ensure that things run the way he wishes. SAMR has already been involved in Ant regulation, in the Meituan events, and in fields as far ranging as food and drug safety.

It talks about strengthening "supervision and law enforcement" in areas such as platform economy, scientific and technological innovation, information security, and people's livelihood security. The anti-monopoly mechanism should be improved and the anti-monopoly supervision force should be strengthened.

The second distribution is the government. Mainly, the government will redistribute to the middle class. This is due to tax reform. "Increase the regulation of taxation, social security, and transfer payments." The tax statement seems to be talking about the individual level though not corporate. There isn't even currently a definition of "high income" in China. For corporates, the land tax has been put on the legislative agenda. This is because so much of local political economy is due to land. For example, indebted real estate giant Evergrande has seen all of its many debt cases placed under one jurisdiction so they can be resolved prior to their next overseas bond being due in March next year.

The final distribution is from society. This is nearly solely from China's wealthy private entrepreneurs. Fortune magazine calculates that in the past eight months five of China's richest tech moguls have pledged at least USD 13bn in personal and corporate wealth to charity.

Where this private money is going gives some hints as to what the government is looking for. Pony Ma, the founder of Tencent, is giving away USD 7.7bn to village revitalisation initiatives, as well as clean energy and education. Wang Xing, the founder of food delivery platform Meituan, is handing over USD 2.3bn for education and scientific research. Pinduoduo Inc., China's largest online retailer by consumer, has pledged to donate all future profits to address critical needs in rural areas — up to a total of CNY 10bn (USD 1.5bn).

And, sure enough, in Xi's speeches he calls for improving "the balance of regional development and "continued development of rural China". They mention improving healthcare, housing, care for the underprivileged, etc. And they focus especially on making China more competitive internationally.

## What is currently hanging in the balance

There are a few more parts of Xi's remarks that seem far less simple to ascertain; more importantly, perhaps, they appear less coordinated. There isn't the joining of tech entrepreneurs saying the same thing as the government for example. Rather, this is where multiple interests are colliding. The problem with grand visions is that they lead to winners and losers, and when the final destination is still vague then everyone wants to fight. The box below gives an overview of the key fights within the government.

### Common prosperity battlegrounds

The first is the constant focus on the environment. Xi wants to make China green. But no matter how genuine this wish, such a transformation will be difficult. His own cabinet briefing is clear that "while our country's energy system is highly dependent on fossil energy sources such as coal, the system of production and living are under great pressure to transform to a green, low-carbon nature; to achieve the goal of carbon emissions peaking by 2030, carbon neutrality by 2060 is extremely difficult." The only sign we have thus far in how this will be improved is an April meeting of China's leaders who noted that "The high energy consumption and high emission projects that do not meet (relevant) requirements must be resolutely taken down." What to do when a high energy consumption project becomes a "common prosperity" project remains unclear.

Another is how much China can maintain an open economy while also becoming "self-reliant". Common prosperity has the line that China will "expand openness under the premise of ensuring security", which reads as almost paradoxical. It also highlights that foreigners will need to embrace some level of risk. China at the macro level itself is to allow and encourage foreign capital while also "improving the reserve system for materials of strategic importance or for emergency use." It should also bring in international talents and technology while developing scientific and technological self-reliance and self-improvement... this has become the basic capability that determines the survival and development of China — there are many "chokepoint" problems. Under such circumstances, we must put more emphasis on indigenous innovation. The question, though, remains: will foreigners want to come in under these circumstances?

The final part is internal, as Xi tries to make common prosperity itself an ideological position that everyone must study. "We must promote the common prosperity in the spiritual [moral] lives of the people, strengthen the guiding influence of the Socialist Core Values, and continuously meet the diverse, multi-leveled, and multi-faceted spiritual, moral, and cultural needs of the people. We should strengthen public opinion guidance on the issue of promoting common prosperity to provide a favourable public opinion environment for this enterprise."

## Common prosperity will not make China un-investible

Why this rhetoric, especially given the potential for it being misread? One reason is due to the strong pressure from within China to be ideologically pure. Already, fire-breathing editorials from retired left-wing Party members have been published in official newspapers.

"This is a return from the capital group to the masses of the people, and this is a transformation from capital-centered to people-centered," a recent commentary said. "Therefore, this is a political change, and the people are becoming the main body of this change again, and all those who block this people-centered change will be discarded." The capital market will no longer become a paradise for capitalists to get rich overnight," it continued . "The cultural market will no longer be a paradise for sissy stars, and news and public opinion will no longer be in a position worshiping Western culture."

From the outside, editorials such as these can be taken as a revolution; indeed many media outlets write about it as such. We don't see it as such.

Common prosperity is seen as the end point of development rather

than a different way to do development. It is this need to develop the economy rather than just soak the rich that is likely to act as Xi's greatest restraint.

Rather, it is China tackling many difficult problems that all nations face once past a certain stage of development.

Take for example the high housing prices and medical costs. China spends relatively little on healthcare. Education in rural areas is chronically underfunded. This helps account for China's high savings rate. In striking contrast to most other countries, the poor in China save 20% of their salaries in case they get sick or need cash for other emergencies. On this, the editorial discussed earlier is completely aligned with government priorities.

Or let us examine tech billionaires, who have contributed billions to various government campaigns. Taking them fully down through going after their business model (i.e., stopping Alibaba from taking 20% per transaction) would no doubt be very popular. But the VAT, which is now over half of Chinese tax revenue, goes half to the central government and half to local governments, and is the main source of revenue other than land.

Say Alibaba can no longer serve small time entrepreneurs, there would be no AliPay and Ant would therefore no longer be a credit provider. Local governments would be perhaps the hardest hit. Credit for their local businesses would be difficult. They would be unable to meet most central requests for Xi's signature projects such as the anti-poverty campaign, as the payments system is increasingly relying on Alibaba and Tencent rather than on bank accounts. So smashing tech giants would also vastly hinder local development, which would hurt common prosperity.

Common prosperity is therefore not likely to smash neither capital nor tech. In Xi's own speech on the topic, he says that "finance is the core of the modern economy; it has a bearing on both development and security. It is necessary to abide by the principles of marketisation and legalisation, and coordinate and effectively carry out the work of preventing and resolving major financial risks." Similarly, economic development documents issued prior to common prosperity were on using technology to govern; not to mention a constant theme in central committee documents of how to use technology to govern.

This new form of development will, however, have a very populist touch. There have already been mentions of common prosperity in recent policies related to school district houses, after-school tutoring, property tax pilot programs, "anti-trust and reckless capital expansion", as well as a demonstration zone launched in Zhejiang province for achieving common prosperity.

Further, the government announced a probe into people who have avoided taxes, and has vowed to implement guidelines that were issued in March this year on taxing high-income and high-net-worth individuals. First in the firing line are pop stars and actors.

There has finally been a high-profile new data privacy regime launched. These new rules seek to stop internet companies from using algorithms for a range of reasons. They give a huge amount of protection to the users. They also continue previous actions against Meituan and other delivery firms: [Algorithms must not dictate] brutal work conditions for ride-hailing drivers, delivery drivers" and against the tech giants "providers shall not use algorithms to implement unreasonable trading conditions such as differential treatment and transaction prices based on consumer preferences and transaction habits and other illegal acts." Both of these things we discussed already in our piece on Regulators strike back. These popular data privacy rules could hit hard against companies wishing to list in the US. That is because companies with data privacy issues will not be allowed to list overseas (Hong Kong is counted as inside China for this rule).

## What comes next for foreign firms

The common prosperity doctrine definitely increases the need for foreign businesses to know more about conditions on the ground in China. It will make it more difficult to move capital in and out of the country — as Xi puts it: "on the macroeconomic front, we should prevent big ups and downs, prevent foreign capital from entering and leaving the capital market rapidly on a massive scale". There will also be risks for foreign firms should they be seen as hindering national security.

These are not trivial points. Common prosperity is being taken uncommonly seriously. But at the same point, common prosperity is built on learning from the outside world. There are lots of documents talking about common prosperity; the highest and most authoritative one states overtly that China must "draw on the experience of other countries in national security". Indeed, Xi continues to say that "The interests of our companies have extended to all corners of the world, everyone should pay attention to understanding international affairs, deeply study countries that are stakeholders, trade partners, and investment targets, so as to have a clear picture and avoid harm."

Learning is best done through doing. By telling the vast Chinese system that it must deal with the outside world, Xi is telling China's millions of lower-level officials — ministers, provincial and municipal leaders, major Chinese firms — that they must engage. Overseas investors and firms may therefore face new rules, but also they will have the opportunity to be useful. And the tides of world affairs are fairly clear: China is roughly 20% of the world's economy and yet has only 4% of total global financial assets invested. So while one must be mindful of the rips, many opportunities can flow from China's common prosperity.

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