China Briefing

Schooled by education's new rules

Executive summary

- *China's sudden imposition of strict education rules has spooked investors and smashed companies.*
- *These actions were heavily foregrounded, and warnings made regularly from 2018; the problem is one of reading the signals.*
- *Beijing has been saying clearly for a long time that it wants to control what is taught, and by whom. This time, they have reached for the sledgehammer rather than the scalpel, smashing investors.*
- *But this does not presage the end of the sector, nor a crackdown on technology more broadly. Rather, it is making education more like healthcare: an attractive, high-growth sector as long as one does not try to run a hospital or, now, a K-12 school.*

Schooled by education's new rules

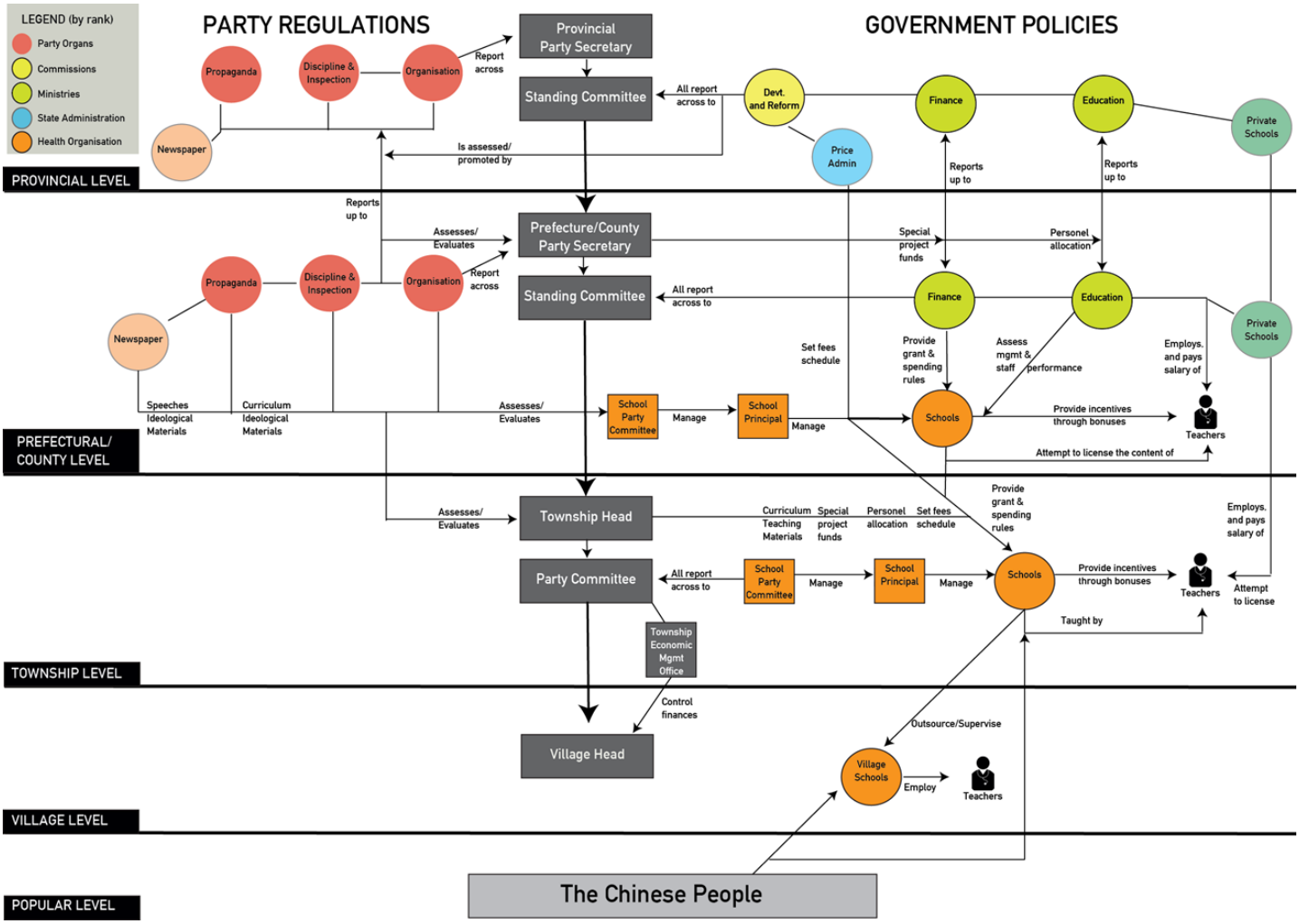
Education in China is always going to be an attractive sector. China has a very large population, a high base rate of literacy and numeracy, a traditional respect for teachers and scholastic excellence, and a single life-changing winner-takes-all exam system. This is fertile ground for selling education services.

There are some 240 million school-aged students. In 2019, education was 17% of annual urban household spending. And that was before COVID meant that everyone had to study from home. Pressure, as the cliché goes, makes diamonds. But when that starts so young and affects education, it also can be suffocating for parents and students. And it has led to China's ruling Communist Party to wish to have far more control over what is taught to students and by whom.

Everyone is seeking the same goal — to teach millions of young people. It is just that parents, investors, and the Chinese government view China's fragmented and often inequal education system through different eyes.

You say market opportunity, we say public good

China has long been worried about educational quality. Part of that stems from China's formal education system being enormously complex from a regulatory and government perspective. There are a number of regulators, each in charge of different rules. The diagram below describes.



Why does this matter so much? Because, as the complicated diagram above shows, the central government has too many regulators that are charged with affecting education. Changes to education regulation, for example, could come from the Ministry of Education — but these could interfere with curriculum and content orders from the party's Propaganda department and fiscal mandates passed down by the Ministry of Finance. When this was multiplied by the thousands of different counties, hundreds of municipalities, and dozens of provinces, things were a mess. Beijing's solution for this has traditionally been to pass the buck to local governments, so that if anything went wrong it would be seen as their fault and not the centre's.

From the government perspective, 2018 was the turning point for trying to fix this. Xi Jinping himself gave a 2018 speech promising to regulate the sector better and lower the pressure on parents. The Chinese government began releasing a series of new regulations governing both after-school tutoring ("**AST**") and online education providers. There were many confusing and overlapping regulations issued. The key, however, was that curriculum changes became the front line of fights over education. Local governments were demanded to tighten down on what was taught, and told to improve teacher quality.

There were many activities trying to enforce this. Teachers were to be bound by rules forcing ideological compliance as well as normal educational rules. Central education bureaucrats developed a 'comprehensive training system'. The Party rewrote various school curricula in order to focus on students' "patriotism, law-abiding, innovative thinking, physical standards, aesthetic ability, labour practice, and other aspects." Kindergartens were told to cut their foreign ties, and US-listed companies saw their share price fall precipitously.

The problem was that this regulatory activity could not solve the problems of fragmented provision and low teacher quality. Parents need to navigate China's enormously competitive education system. Local government leaders are held accountable for thousands of metrics other than education. And China's life-changing examination system will always generate extraordinary pressure to get ahead.

This messy regulatory environment and the many rules and providers made the education sector ripe for a technology-driven solution.

Chinese companies read regulatory tea leaves extremely well. And tech firms are better than most. They innovate quickly, which keeps them ahead of more rule-bound bureaucrats. They play off

different departments and interests in the Chinese system, and game geopolitical changes to their advantage. That said: they also know when to stop. Challenging administrative decree is a risky game. So firms tend to follow orders. But if there is nothing telling them "no", then China's cut-throat environment means that they will take every opportunity they can.

In this case, the opportunity was the fragmented regulatory environment combined with the constant growth in enrolment in AST, and in online education classes designed to help students get ahead. Edutech startups boomed. In 2020 for example, USD 10bn of capital was estimated to flow into Chinese education venture capital.

These startups followed a classic playbook: launch an app, spend whatever money possible on getting customers, raise more money to be spent on gaining customers, list at a very high valuation, and then use that capital to gain more customers. As with the government, the goal is to provide services all over China's vast lands and population.

Everyone was racing hard to keep up. The pressure kept mounting. And China's leaders were regularly promising to do something about it. For the government, something had to be done.

Steady signals

The first method tried was to try and have more inspections to make sure everyone was following the 2018 and 2019 rules. Why do this? Because using inspectors is much less permanent, and quicker, than drafting an actual policy. This sort of intervention is a quick way to show that something is being taken seriously, and to get companies and local governments to respond.

Early in 2020, the Ministry of Education, along with five other central regulators, launched a campaign to check the operations, course content, and teaching qualification of online training providers. The release of the final report in January 2020 said that central regulators checked "3,463 courses and 115,622 teachers of the 718 online training course providers." Official media reported that the campaign was "expected to result in a provincial blacklist of the unqualified or poorly run online training providers and to suspend or shut down their services."

But the online education sector kept growing, and with this growth came head-turning events. Online education advertisements were prominent for the past few years in the annual New Year gala, one of the very few global events where television viewer ratings are measured in the billions rather than millions. And in early 2021, there was a scandal where four education firms all used the same supposed professor in advertisements designed to scare parents into enrolling their children; leading to four times the trouble when said professor was shown to be a shyster.

China's leaders rapidly made their displeasure known. A high-profile hit piece was published in the Beijing Youth Daily, a newspaper for officials, on February 18. This pointed out that the education market had become very heated and made clear that officials were to act. Xi Jinping himself used an annual visit to a delegation to China's legislature on March 6 to promise to clean education up (similar to his 2018 speech). Local governments ran more inspections, similar to the 2020 campaign. Central regulators in different departments kept finding fault with AST companies.

Rumours began to spread. On March 15 it was alleged that a pilot project cracking down on education had already been designed and would be pushing a "double reduction": measures to reduce the burden from homework, and from AST for compulsory education students. The document alleged that regulations are expected to be issued by the State Council at the end of the month. While the post did not turn out to be correct, the very fact that it was not censored and was allowed to spread so widely is itself a signal. Top leaders have many tools to make sure that messages that are not aligned with policy do not spread.

This steady drumbeat of signals all presaged the growing concern of China's leaders with how the education sector was developing.

2021 major regulatory changes
6 January 2021 Report of the National work conference for the Ministry of Education. The Ministry proposed to make great efforts to regulate and rectify AST institutions and formulate a governance plan as soon as possible.
20 January 2021 The Ministry holds meetings with online tutoring companies; these were not formal documents or measures but rather "discussions of concerns". Among the regulators' concerns were excessive advertising spending and companies misappropriating prepaid tuition fees.
3 February 2021 The Ministry of Education work requirements outlines what they were planning on doing for the year, and specifically mentions tightening policy.
18 February 2021 *Beijing Youth Daily* editorial on page 2.
6 March 2021 Chinese President Xi Jinping called disorder in the tutoring industry "a stubborn malady" and vowed to solve the problem to medical and health education committee members attending the annual meeting of China's legislature.
10 March 2021 Online rumors that there would be a "double reduction policy".
31 March 2021 The Ministry of Education issues an Opinion on the promotion of kindergarten and primary school classes (linked to curriculum changes, based on a range of 2018 activities). The Opinion said that primary schools are not allowed to hold entry exams, while kindergarten primary schools are forbidden from holding preschool courses.
31 March 2021 The State Council and the Ministry of Education held a press conference to discuss the 14th Five Year Plan for education. The Ministry then commented on the AST industry, said that it would "tighten scrutiny of AST institutions and investigate and punish illegal training activities and... regulate off-campus competition programs."

25 April 2021
The Ministry of Education names several large online education companies as violating regulations on selling too many months of courses in advance. The companies were ordered to fix these problems, and publish corrective measures, but were not fined.

7 May 2021
Beijing Party secretary (in top 25 most powerful people in the country) and mayor met with representatives from public schools and leading AST companies to warn them about the possibility of the so-called "double reduction" policy.

17 May 2021
State Council circular restricting foreign curriculum and foreign ownership of schools catering to kindergarten to 9th grade students.

21 May 2021
The Central Commission for Deepening Reform, perhaps the most important policymaking body of China, issued a specific notice on education. This was then republished on CCTV, and notified on the front page of the People's Daily. It listed the two broad goals for education and after-school tuition as being "supervising them more closely" and aligning better with central goals. It did not mention any reduction in advertising specifically.

1 June 2021
The Law to Protect Minors was amended by the central government to ban the teaching of any school curriculum to preschool students and 15 AST companies are punished by the anti-monopoly regulator over false claims, exaggerations in their claims of their education, and misleading parents.

15 June 2021
The Ministry of Education creates a Bureau of Supervision of Off-Campus Education to regulate private tutoring services that target middle and primary school students.

22 June 2021
National Development and Reform Commission inspects Chongqing kindergartens, outlines how it wishes kindergarten reform to proceed for the forthcoming year.

Cracking down

Finally, on July 23, China's leaders stepped in. They issued a rare joint Party and government opinion ("**the Opinion**") on reducing the burden for parents and regulating education activities.

Understanding China's actions is an exercise in continuity. It is clear from the preamble that the central government's actions were based around two goals: having more control over content, and easing the minds of parents. In this sense it is a continuation rather than a punctuation. Either way, though, the themes are consistent with the signals provided from 2018.

Most of the concerns are similar to those listed above. First, with regards to teacher quality and control of the curriculum, it restricts teaching to formally qualified professionals. It also promises to crack down hard on moonlighting teachers. (Indeed, there has already been a high-profile punishment of a teacher for acting outside of class). Foreign teachers are not allowed to teach on compulsory courses.

Secondly, the Opinion addresses public opinion. It promises three specific measures: strictly reviewing and approving AST institutions, and no longer approving new AST bodies. Second, standardising tutoring services, which will reduce the ability for AST bodies to charge price premiums. Also, all prices will have to go through education regulators. (This part is aimed at stopping cheap, subsidised trial classes that convert into expensive, long, non-subsidised classes). Thirdly, ban advertisements for online or offline AST bodies.

This shifts responsibility totally back to public schools. They are now to provide more after-school services to students, and to "focus on the development of comprehensive and quality education".

Parts of the Opinion are much stronger than one might have expected. It destroys many listed companies' business models. "Local authorities should severely investigate and deal with non-school-subject related AST institutions that do not have corresponding licenses and institutions that carry out training in multiple locations without approval according to laws and regulations." So AST companies are not meant to be run centrally using technology but rather will need to re-register with local governments, and are meant to become "non-profit" (more on that later). Authorities will no longer approve K9 AST institutions that teach school-subject related classes. Foreigners are not to do any tutoring. All of this makes using technology, AI, and cheaper labour to provide services far more difficult.

China's rapid growth in edutech firms was funded by a rapid influx of money. On this, the Opinion is very blunt: "School-subject related AST institutions shall not list on stock exchanges for financing. Operating based on capital-related principles is strictly prohibited for school-subject related AST institutions. Companies listed on stock exchanges shall not invest in school-subject related AST institutions through stock market financing, and shall not purchase the assets of school-subject related AST institutions by issuing shares or cash transactions. Foreign capital shall not hold or participate in school-subject related AST institutions... Those school-subject related AST institutions who already are in a state of not complying with the new rules shall make the arrangements to comply with the new rules."

This has been described as a death knell for edutech in China.

What comes next?

This is by no means the end. Even a joint opinion can be overridden (it is the sixth-highest document class). This statement's goal is to signal what the top leaders want. It is the job of the rest of the system to respond to this opinion and tell the leaders how they will make it flesh. So there are still a number of slips between cup and lip before the final policy is settled.

Contrary to the idea that this was a sudden shot across the bow trying to kill an industry, the Opinion states that central leaders expect this to be a three year process. There is significant time lag built into the opinion: "Students' excessive homework burden and after-school training burden, family education expenditure, and parents' corresponding energy burden should be effectively reduced within one year. Significant improvements should be achieved within three years."

We think the reason for this time lag is that the Opinion is not enforceable. It is a statement designed to look as scary as possible so

that China's leaders look like they are taking the matter seriously.

But it cannot be made flesh. Local governments are meant to do all the lifting, and there is not the money, nor time, nor ability. Local top leaders, the heads of their jurisdictions, are to "prioritise" double reduction work. They are to instruct public servants and Party members alike. But these leaders are responsible for everything that happens in their jurisdiction. They face thousands of indicators upon which they are measured every year. And they have to juggle their responsibilities to the Party, which wants them to focus on ideological training; to the government, which wants enough money and resources to fulfil their orders; and to the people, who want their kids to succeed in competitions literally involving millions of people. That's impossible. It is safest just to do exactly as one is told.

And if one does only what one is told, then much of the Opinion is unenforceable. Many issues cut across Party and government, and across different silos that don't speak.

Advertising is to be banned, for example, but there will need to be four different regulators coordinating to ban it. Three different departments have to enforce the Opinion on banning AST advertising in "all kinds of billboards and internet platforms, mainstream media, news media, public places, and residential areas" while the Ministry of Education must enforce the ban in "primary and secondary schools and kindergartens", and in "teaching materials, teaching aids, exercise books, stationery, teaching aids, school uniforms, school buses, etc. of primary and secondary schools and kindergartens". How can one distinguish what is an ad for AST specifically, as opposed to for other non-banned goods? And how can four different departments replicated across 800 prefectures come up with a standard definition of AST advertising?

There is a similar problem with allocating teachers. Capacity problems are meant to be solved by the education department, who can "allocate outstanding teachers in the region to tutor after school in schools with insufficient teacher quality".

This will make the education bureau's job very difficult, as they will have to determine who is outstanding, who is of poor quality, and also figure out how the "outstanding teachers" are to be motivated for extra teaching without paying them extra and thus violating the clause in the Opinion on not paying current teachers for AST.

More broadly, local governments now are to spend more on education to make up for what the private sector is banned from providing. They are to act as stricter proctors on exams and curricula. All local authorities should, according to the number of students and the staffing standards of primary and secondary school teaching staff, make an overall plan to verify the staffing and allocate sufficient teachers. Somewhat ironically, they are to collect and develop rich and high-quality online education and teaching resources covering all grades and provide them free of charge.

This is similar to what happened in healthcare in China. Unfunded mandates from the centre came down. Local governments were meant to make hospitals non-profit but also ensure that the local jurisdiction didn't go broke. They did this by letting hospitals charge fees for various services and trying to hold essential services at constant cost. It failed. Demand for healthcare (like education) is constant and ceaseless, and so everywhere the centre squeezed, other parts of the balloon bulged instead.

So the crackdown is likely to make a difference mainly on capital raising and initial business models. Banning advertisements would greatly hurt online players, who currently lose money due to high customer acquisition costs. Should businesses be unable to advertise their wares on WeChat etc., they would not be able to have explosive growth. Rather, they would rely on retaining students, word of mouth, and expanding their services throughout China. This will help their profitability, as marketing spend at present is very high, but it will not lead to explosive growth in enrolment, and that will greatly hurt valuations. It is also calling into question how Chinese firms list in the US, although according to Bloomberg, regulators already had a meeting with major investment banks to reassure them this would not be a problem.

But we think Chinese firms are well and truly able to adapt. Passing things over to local governments is a fragmentation and cost inflation nightmare. Local governments and schools will need the private sector's help like never before. Deloitte estimated that China's after-school private tutoring market would be RMB 564bn (USD 87.65bn) in 2021. That is an enormous burden for the public sector to bear.

Private firms will just adapt their models. There are many possibilities to avoid the Opinion. Instead of running things from Beijing, and trying to make everything standardised, firms could return to more traditional techniques of establishing a presence in each city and selling a mix of online and offline services. They could offer services but use different payment options that are harder to track for regulators. Or they could move their headquarters to cities with less ability to crack down than Beijing. Finally, firms could just relabel their operations as being on "comprehensive education" rather than focusing on subject-specific training.

That doesn't mean that things will be simple. At the moment it is hard to predict who shall survive and how. Firms with cash in hand and a management that is best able to adapt to a new environment may be better able to evolve. Or else it may be that new players disrupt the market by focusing on comprehensive education.

Either way, Chinese firms tend to be excellent students. We would bet on them passing this test.

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