BEIJING—A mid-July move by China to increase the power of the market in the banking sector was a significant step in a plan to overhaul the country’s economic model. It may also have been the last easy win for China’s new leaders, whose reform program will likely run into stiff opposition from within the ruling Communist Party.

President Xi Jinping and Premier Li Keqiang have advocated a more limited role for the state, and with economists convinced that Beijing’s investment-heavy growth model has run its course, the government has signaled its aim to rebalance the economy toward domestic demand.

Beijing moved last month to scrap a government-mandated minimum interest rate on bank loans. But further proposals to inject more market forces into the economy face a daunting review process. That is likely to dilute them and could keep them off the agenda altogether at a meeting of the Communist Party’s senior leaders, which is expected by year’s end—which aims to agree on a package of structural shifts in the way the country’s economy is organized.

The meeting—known as the Third Plenum—will be charged with historical significance. The Third Plenum in 1978 saw Deng Xiaoping outmaneuver Mao Zedong’s chosen successor, Hua Guofeng, and set the country on the path to a market economy. In 1993, the meeting laid the groundwork for shrinking state-owned enterprises, a tough sell that left millions out of work.

This time, Liu He, the head of the party’s internal financial leading group and a known reformer with a reputation for pro-market instincts, is heading the small work teams that will draw up specific economic proposals, according to Cheng Li, an analyst at the Washington-based Brookings Institution.
"Liu He has a very solid pedigree," said Mr. Li. "He has worked in finance for 15 or 20 years. He's a talented economic technocrat." A key question is whether those skills will be enough to overcome formidable opposition to the overhauls.

Leaders are expected to call time on the development model that has served China well for decades. That model has been based on high levels of investment in industry and infrastructure subsidized by artificially low interest rates and on an army of rural migrant workers manning China’s factories in cities without drawing urban benefits, such as access to local schools and health programs.

Small working groups under the direction of senior officials are now trying to hash out a set of proposals that can be presented in the fall, according to Yiping Huang, an economist who has advised the government in the past.

Changes under consideration include lifting restrictions on land ownership and urban residency, adjusting the tax system to give more resources to cash-strapped local governments and relaxing controls on energy prices, Mr. Huang said. Financial reforms to free up interest rates on bank deposits and allow money to flow more freely in and out of the country are also near the top of the agenda.

Yet many prospective overhauls would cut against the interests of arms of the state. State-owned banks would find themselves forced to pay more competitive rates to depositors. Local government officials could have to pay for extra social spending in growing city populations, and it isn't clear whether new tax-raising powers would be enough to compensate.

"People are attaching a lot of expectations to fiscal reform, but I doubt there will be any substantial progress on that. It's difficult to balance the interests of central and local governments," said Yao Yang, an economics professor at Peking University.

Central to the leaders' plans is Premier Li’s goal of moving more Chinese into cities, which he says will drive growth and raise private consumption. In an example of the hurdles ahead, a government planning group drawing up ideas for this urbanization program saw its proposals watered down by other ministries and government departments, according to a researcher close to the group, which is under the National Development and Reform Commission.

"The controversial items in the draft were deleted" as it went through the consensus process that most draft proposals must take in China, the researcher said.

Allowing 260 million migrant workers already in China’s cities access to urban residents' benefits could add to competition for housing and education and pile more financial pressure on overburdened local governments.

Plans to change the household-registration system, which dictates where people can settle, may end up being softened thanks to lobbying from local governments and the fear of upsetting some middle-class urbanites.

"Arguments still exist, such as if we really want to reform, and how to balance the relation between the government and market," said Huo Jianguo, president of a think tank affiliated with China’s Ministry of Commerce.

According to the few details of the government’s urbanization plan released so far, the change would begin in smaller cities—leaving the status of millions of guest workers in major cities undecided.

"Generally policy makers prefer to promote migration to smaller cities, but this is a flawed approach," said Yukon Huang, a former World Bank country director for China now at the Carnegie Endowment for International Peace. It is already easy enough to get residence rights for a small city, Mr. Huang said. "The productivity gains from labor migration lie more in the larger cities," he added.

With senior leaders focused on urbanization as a priority, it is possible that the final proposals will be bolder in extending urban residence rights to migrants.
The difficult birth of the plan reflects the hurdles China’s leaders face as they try to push overhauls through a political process that depends on consensus within the Communist Party. The excesses of the Mao era led the party to diffuse power among a number of officials and bodies, while patronage networks mean former bosses such as retired President Jiang Zemin can still wield power in the political dealing necessary to get big measures passed.

"Often big reform proposals can take two or three years to be completed," said Zhang Yansheng, an economist at the NDRC who isn’t directly involved in drawing up the urbanization proposals. "The process is always quite long."

—Richard Silk, Yajun Zhang and Tom Orlik

A version of this article appeared August 27, 2013, on page A8 in the U.S. edition of The Wall Street Journal, with the headline: For China Reformers, Hurdles Begin.