

China in the Global Economy



# Governance in China



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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Publié en français sous le titre :

**La gouvernance en Chine**

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## Foreword

**T**he OECD and the People's Republic of China have been engaged in a comprehensive programme of co-operation since 1995. In 2002, soon after China became a member of the WTO, the OECD published a landmark report, *China in the World Economy: Domestic Policy Challenges* which reviewed the policies needed to reap the benefits of China's further integration in the world economy.

Improving governance mechanisms and practices is now widely seen as a critical requirement to ensure continuing progress by China on its rapid development path. Redefining the role of the state, modernising public management, adjusting relations between levels of government and consolidating the institutional framework for market forces are key if China is to take the transition and development processes one step further. Improving governance will also be crucial to address the problems that threaten the sustainability of China's growth path, such as growing inequalities and environmental deterioration.

These considerations led China and the OECD to make governance the focus and the “unifying theme” of their programme of co-operation for 2003 and 2004. The launch of the China Governance Project led to two years of intense policy dialogue on governance issues and their impact on public action in several sectors. The project aimed to analyze current practices in China and share with Chinese policy-makers the experiences of OECD member countries on how to improve governance in order to help ensure sustained growth and social cohesion.

This report, covering the results of the China Governance Project, includes contributions from all relevant OECD Directorates and was jointly co-ordinated by the Directorate for Public Governance and Territorial Development and the Centre for Co-operation with Non-Members. The report provides a unique set of insights on governance practices in China and their recent evolution. It identifies a number of key challenges and discusses ways of addressing these in order to enhance the capacity of Chinese authorities to achieve their policy goals and ensure sustainable development.



Donald J. Johnston  
Secretary-General of the OECD

## About the Study

This study has been undertaken in the framework of the OECD-China programme of dialogue and co-operation. It draws on the understanding gained from several years of dialogue with a number of Chinese ministries and institutions. However, the report remains an independent study of the OECD Secretariat and is published under the Secretary-General's responsibility.

**Acknowledgements.** This study has been produced by an OECD-wide team, which has been led by Irène Hors and overseen by Frédéric Langer for the Center for Co-operation with Non-Members and by Jón R. Blöndal for the Public Governance and Territorial Development Directorate.

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Research support for the synthesis and editorial support: Isabelle Gras. Technical assistance: Jennifer Gardner.

Experts from OECD member countries and China contributed important comments on the study in a seminar under the auspices of the Public Governance Committee on 3 February 2005 in Paris. Experts from China, who took part in their personal capacity in this seminar, were: Mr. Yanfeng Ge, Development Research Centre; Mr. Haiyan Li, National Development and Reform Commission; Mr. Zhaoxi Li, Development Research Centre; Ms. Wei Lu, Development Research Centre; and Ms. Hongri Ni, Development Research Centre.

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# Synthesis





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# Synthesis<sup>1</sup>

## 1. Introduction: the China Governance Project and the Chinese context

Governance is recognised as critical to economic development and the achievement of a society's objectives. OECD member countries target a development path built on three pillars: good governance, economic growth and social cohesion. Good governance<sup>2</sup> is thus seen as a crucial element to address challenges and fault lines facing a nation and to ensure sustainable development.

China is now undergoing a crucial transformation in its system of governance, adapting institutions and the functioning of the state to an increasingly market-oriented economy. This transformation is also being spurred by key strains that have emerged related to fiscal and financial imbalances, rising inequalities and environmental deterioration.

In 2003, the OECD initiated a project to share with China the expertise of its member countries on governance issues. The China Governance Project was also the opportunity to better understand the challenges faced by China and to organise policy dialogues on these issues. This project was undertaken in the framework of the programme of co-operation between the OECD and China, initiated in 1996. It thus benefited from a relationship of mutual trust established between the OECD Secretariat and Chinese ministries and bodies in many areas.

The first section of this introduction describes the China Governance Project. The second section gives an overview of changes that have affected the Chinese system of governance since the beginning of the reforms in the late 1970s. The third section points out the challenges ahead and outlines the overall structure of the synthesis.

### 1.1. The China Governance Project

The project took both a whole-of-government and a sectoral approach. In the whole-of-government approach, the project took stock of the progress made and examined remaining problems in budget processing and public expenditure, the tax system, the civil service, the fight against corruption, regulatory management and organisational structures of government entities.

The sectoral approach looked at how governance issues affect policy-making, its efficiency and effectiveness in different sectors. Again, the idea was to review progress made and to identify and analyse remaining weaknesses. The project covered 10 policy sectors: labour policies, the banking sector, competition, intellectual property rights, foreign investment, statistics, corporate governance, agriculture, environment protection and higher education.

This project took the dialogue beyond the general statement that “governance matters”, by showing how, in practice, governance indeed affects public action in the different policy sectors covered. The following issues contribute to weaken public action:

organisational weaknesses (*e.g.* institutions inherited from the planned regime co-existing with “new” institutions that have been added one after the other), fiscal issues (*e.g.* mismatch between responsibilities and resources), managerial issues (*e.g.* low quality bureaucracy in poorer areas), central-local relations issues (*e.g.* decentralisation not accompanied by appropriate reorganisation of state structures), inadequate accountability structures and inadequate participation mechanisms in policy-making.

This study is the final report of the China Governance Project, organised in four parts: two whole-of-government parts, public sector management and public finance, and two policy sector parts: the institutional framework for market forces and sustainable development. The synthesis gives an overview of the analysis and conclusions of the 18 chapters of this report.

Several important dimensions of the system of governance are not covered in this report (*i.e.* organisation of elections, constitutional law, etc.), either because they do not pertain to the mandate of the OECD or because OECD-China co-operation has not yet been developed in these areas. The ambition of the report is not to provide a systematic analysis of China’s governance system, but rather, through several entry points, to grasp some of the highlights and difficulties of the ongoing process of state reform.

In addition to descriptions and analysis, the chapters provide some key messages drawing on the experience of OECD member countries. It is hoped that they will provide landmarks for policy-makers and serve as a basis for further policy dialogue with China.

## **1.2. China’s governance in transition**

Since 1978, China has undertaken comprehensive reforms, which progressively transformed the former planned economy into what has been designated by Chinese leaders as a “socialist market economy”. Framed in successive themes (*cf.* Box 0.1), the reform process was primarily driven by the desire to transform the economic system, but it also reconfigured the Chinese state and the system of governance. The following paragraphs sketch the transition process and provide landmarks on the evolution of the Chinese system of governance since the beginning of the reforms.<sup>3</sup>

Before the reforms, economic activities were tightly controlled, the state’s control affecting not only the types of products produced, but also the quantities, pricing and distribution. The provision of raw materials, the distribution of funds, the staffing of technical personnel, agricultural production, the allocation of grain, textiles, and even paper, were controlled by the state.

China’s economic transition has brought significant changes in all dimensions of the economy. Recognising that the system in place discouraged productivity, Chinese leaders authorised the development of a productive capacity outside of the state sector, first in rural, then in urban areas, by establishing collective enterprises, then private enterprises. This implied a progressive liberalisation of prices and an evolution of the monetary regime. The development of the private sector also called for an evolution of the financial system, away from being a passive channel of allocation of financial resources toward an important mechanism of the market economy. The progressive opening of the Chinese economy to foreign trade and investment, culminating in China’s accession to the World Trade Organisation in 2001, is another important structural dimension of the transition process.

**Box 0.1. Theoretical framing of China's transition:  
from the Four Modernisations to the Harmonious Society**

The theoretical framework underpinning the transition process started with the concept of the *Four Modernisations* (*sige xiandaihua*), announced by Zhou Enlai in the mid-1960s and revived by Deng Xiaoping to launch the economic reforms in 1978. It envisaged the development and rise of the Chinese economy until the middle of the 21st century by modernizing agriculture, industry, national defence and science and technology.

In the mid-1980s, Deng Xiaoping elaborated a development strategy of “three steps” quantifying political and economic objectives. The first step or objective was to double the level of real GDP during the 1980s and thus solve the problem of inadequate clothing and food (*wenbao wenti*). The second step was to build a *Xiaokang* (*well-off*) Society by the year 2000 by quadrupling the 1980 real GDP level. The third step was to raise the per capita GDP within the following 30-50 years to the level of an intermediate developed country. The concept of *xiaokang* society is particularly interesting since it was reused (and redefined) by Jiang Zemin to describe “Chinese-style” modernization and notion of prosperity.

The concept of *Three Represents* (*sange daibiao*) proposed by Jiang Zemin in 2000 mainly served to re-orient and re-position the Communist Party of China, but it also officially legitimised private entrepreneurship for the first time.

Two concepts put forward by the fourth generation leadership (Hu Jintao/Wen Jiabao) in 2004, the *Scientific Development Concept* (*kexue fazhan guan*) and the *Harmonious Society* (*hexie shehui*) concept, take on a more comprehensive approach towards development. They complement the discourse about the Chinese modernization path with a social dimension and stress the need to reconcile conflicts between rural and urban areas and between different social groups to promote social stability. The *Scientific Development Concept* moreover accords high importance to the needs of individuals and to a co-ordinated and sustainable development. The *hexie shehui* concept is further linked to the notions of social welfare and more equal income distribution and to the rule of law. As for the role of the government, the concept envisages a closer relation between government and people.

Although obviously incomplete, these reforms have been impressive. Over the past two decades, they have allowed China to develop at an average growth rate of 9%. Today, the transition to a market-driven economy is well advanced, as in 2003 private businesses created 59% of GDP (OECD, 2005).

The evolution in the economic sphere called for changes in the system of governance. Before the reforms, Chinese society was organised in four types of organisations: industrial units (*qiye danwei*), agricultural units (*nongye danwei*), service units (*shiyue danwei*) and administrative units (*xingzheng danwei*). The governance system was quite simple. The power structure was highly centralised as local governments, enterprises, institutions and social organisations had no autonomy and were *de facto* branches of the government in Beijing. These organisations executed the plan under the guidance of the State Planning Commission (now named National Development and Reform Commission, NDRC), and the central government controlled the distribution of human and financial resources. Macro-economic regulation was carried out through the planning system and orders from the government. The allocation of resources was fixed through the plan and controlled by the planning commission.

The departments for sectoral economic management directly controlled the productive units within the sectors they managed. The result was an extensive and bloated bureaucratic structure with bodies generally charged with the responsibility to oversee the production or control of one commodity rather than manage an entire sector of the economy. Overstaffing, functional overlapping and low efficiency were pervasive and debilitating problems. A disproportionate share of public resources was expended on the considerable number of public employees. Consequently the state had no discretionary resources to finance economic and social development programmes.

The transition process has implied a profound reshuffling of the map of power. The role of the state has been changing not only in its relation to the economy but also as a public service provider: private sector entities are becoming increasingly important actors and sub-national governments have seen their role increase. In a schematic way, the transition entailed two centrifugal movements: from a centralised system to a more decentralised system, and from a system in which administrative, productive and social service functions are folded into one same (or closely linked) organisation to a setting in which different functions are undertaken by different organisations.

The reform process has been bringing a progressive separation of state-owned enterprises (SOEs) from the administration and the transfer of responsibility for welfare services from enterprises to local governments. The monetisation of the economy led to the hardening of budget constraints, for SOEs as well as for the administration. Successively, in 1982-1985, 1988, 1993, 1998 and 2003 (see Table 0.1), the Chinese Government conducted five administrative reforms. Each had a different priority, but all contributed to four broad objectives: i) to modify the role of the government; ii) to transform the government's organisational structure; iii) to address the problem of over-staffing; and iv) to increase the efficiency of public action.

In 2002, the public sector employed 69.2 million people: 35.4 in the public administration and 33.8 in SOEs. Only 50 000 worked in core ministries and state bodies, while eight million worked in sub-national governments. The number of public employees has declined in recent years, but mostly as a result of the contraction of the SOE sector. Over the past decade, employment in public administrations and in public service units (PSUs or *shiye danwei*) remained relatively steady. These PSUs, 1.3 million organisations, are in charge of the delivery of services “for the purpose of social public benefit”, most of them in the sectors of health, education, science and technology, and culture. Structures are inherited from the planned regime and are yet to be reformed; the stakes are high as PSUs attached to the national level employ 1.9 million staff, while PSUs attached to the sub-national levels employ 23 million.<sup>4</sup>

The decentralisation process occurred in an incremental and uncoordinated fashion. Beginning in the 1980s, local governments started assuming increasing responsibilities for economic development (see Box 0.2 for an overview of the territorial divisions in China). They intervened in the determination of prices, the establishment of new enterprises and the investment of locally accumulated funds. Public spending also was increasingly decentralised, local government becoming responsible for education, health and housing. As local governments kept an increasing share of locally collected taxes, this created the unexpected consequence of “localism”, in which local authorities sought to protect their industries, as these were important sources of fiscal revenues.

At the Fourteenth National Party Congress of the Communist Party of China (CPC) in October 1992, Chinese leaders acknowledged the need for recentralisation, in order to correct the excesses of the decentralisation of the 1980s. However, local governments at

Table 0.1. **The five major administrative reforms of the transition period**

	Event/document	Objectives/measures
1982/83	12th CPC Party Congress (September 1982) and 5th Session of 5th NPC (December 1982).	<i>Re-organisation and downsizing</i> ; central level: State Council's organs cut from 100 to 61, staff from 51 000 to 30 000; local levels: staff and organs cut. <i>Decentralization of powers</i> . Strengthening comprehensive departments, reducing economic management departments.
1988	1st Session of the 7th NPC (March).	<i>Re-organisation and downsizing</i> ; central level: State Council's organs reduced from 67 to 60, staff from 50 000 to 44 000. <i>Transformation of government functions</i> : separating government bodies from profit-making enterprises, restructuring economic management departments, separating Party and state.
1993	CPC "Directions for Implementing the Restructuring of the Party and Government Units".  State Council: "Provisional Rules and Regulations on Civil Servants".	Overall objective: Government restructuring for a socialist market economy. <i>Re-organisation and downsizing</i> ; central level: State Council's organs cut from 86 to 59, staff reduced by 20%; local levels: 20-30% of staff cut. <i>Transformation of government functions</i> : focus on economic government function, separating government bodies from profit-making enterprises, strengthened macro-control and supervision. Establishment of a <i>civil service system</i> within three years; reclassification of public sector employees; recruitment, retirement and promotion processes formally established; age limits introduced and rejuvenation of civil service accelerated.
1998	1st Session of the 9th NPC.	Most decisive and thorough <i>re-organisation and downsizing</i> of the bureaucracy; central level: ministries/commissions downsized from 40 to 29; more than 200 bureau-level units cut; proposal to downsize 50% of personnel; local level: major cuts. <i>Functional adjustment</i> of the government to meet the demands of a socialist-market economy, focus on separating government bodies from running profit-making enterprises (by abolishing operational bureaucratic control). Increasing central control and macro-management capacity. Promoting the rule of law.
2003	16th CPC Party Congress (November 2002) 1st session of the 10th NPC (March 2003).	<i>Re-organisation</i> : 28 ministries/commissions; restructuring of administrative competencies; set-up of the State-owned Assets Supervision and Administration Commission (SASAC); the State Development and Planning Commission renamed the National Development and Reform Commission (NDRC); the State Economic and Trade Commission merged with Ministry of Foreign Trade and Economic Cooperation to become Ministry of Commerce (MOFCOM), comprising competencies for domestic and foreign trade management set-up of the China Banking Regulatory Commission (CBRC).

the county and township levels are still saddled with unusually heavy expenditure responsibilities, including for areas such as education and health. This has led to a large gap between available financial resources and expenditure responsibilities.

The devices through which power is exercised are also being progressively modified: from governing through economic planning and administrative orders to governing through budget, tax and regulatory tools. In parallel with administrative reforms, China has undertaken important fiscal reforms. The revenue mechanisms of the planned economy became progressively ill-suited to the changing economic regime. This led to a progressive decline of public revenues relative to GDP, down to a low 11% in the early 1990s. The Chinese central government had significantly devolved tax collection powers to local governments in view of increasing revenue mobilisation. The result was that by 1993, the central share of revenues had fallen to just 22% of the total. Fiscal reform therefore became a priority reform issue. The 1994 tax reform overhauled the tax system, adapting it to an



### Box 0.2. Territorial divisions

China has four sub-national levels of state administration and a fifth level which is essentially local. At the end of 2003, the numbers of units were as follows:\*

- *Province level*: 31 units comprising 22 provinces, five autonomous regions and four big city municipalities. The provinces dominate in population terms, having on average over 45.3 million inhabitants per province.
- *Prefecture level*: 333 units. Most provinces are entirely subdivided into prefecture-level cities, whose governments thus administer large areas of mostly rural character, divided into counties, as well as city districts. But 51 prefectures have a different structure.
- *County level*: 2 861 units comprising 1 642 counties, 374 county-level cities and 845 districts in higher-level cities. These units, too, include both rural and urban areas.
- *Township level*: About 44 000 units including 18 100 mostly rural townships, 20 200 towns and 5 750 street communities in cities.
- *Grassroots level*: 680 000 villages with village committees; urban neighbourhood communities (number not known).

\* *China Statistical Yearbook 2004*, Table 1.1.

increasingly market-driven economy and allowed to increase both the share of revenues in GDP and the central share of total revenues. It was only then, in the late 1990s, that attention turned to improving the efficiency of public expenditures. Since 1999, broad reforms in budgeting are being progressively introduced, covering budget preparation, budget classification, treasury management, government procurement and information systems. However, while both the 1994 tax reform and the budget reforms bore fruits, the efforts to build a modern tax and budget system are far from complete. The notion of using the budget process as a strategic governance tool is still underdeveloped in China.

Complementary to these changes in the fiscal system, steps to progressively shift the mode of governance from governing by executive orders toward the rule of law have been taken. Before the beginning of the reforms, orders issued by the CPC and different parts of the government were the main basis for administering state affairs. After the Cultural Revolution, however, China aimed to develop a legal system to restrain abuses of official authority and revolutionary excesses. First in 1982, and again in 1999, the Constitution was revised to emphasise the concept of rule of law by which state organisations are all subject to the law. This turn is widely recognized as a change of significant symbolic importance.

The drive to establish a functioning legal system has brought about the promulgation of 300 laws and regulations, most of them in the economic area. Legislation designed to modernize and professionalize the nation's lawyers, judges, and prisons was enacted. China's entry into the WTO in 2001 also led to the adoption of many new economic laws and the amendment of others. The adoption of laws such as the Administrative Litigation Law (1989), the State Compensation Law (1994) and the Administrative Licensing Law (2003) are important landmarks.

The political regime *de facto* still is a one-party system. Nevertheless within these limits, there has been some evolution towards more checks and balances on the executive. There have been some moves to bring the ruling Party under the rule of law, such as the constitutional amendment in 1999 (United Nations, 2005), with further moves evident from

the policy directions set out in the Fourth Plenum of the Sixteenth CPC Party Congress. In recent years, the National People's Congress has also increasingly asserted its power, through the drafting of laws, but also regarding the design and monitoring of the budget. Another important advancement has been the growing prominence of the State Audit Administration, whose annual reports criticise the Ministry of Finance and other government bodies at the central and local level.

### **1.3. Governance matters to ensure China's sustainable development**

The “growing out of the plan” approach (Naughton, 1995) in economic transition and the gradual reduction of government control have worked wonders in the productive sectors by releasing pent-up energies and resources and improving allocative efficiency. As reflected in the above description, Chinese leaders have been aware of the need to adapt state institutions to an increasingly market-based economy.

Governance improvements appear crucial to support economic growth. The transformation of the system of governance is also necessary to address a Web of fault lines that may otherwise undermine China's development path.

Three sources of pressure on public finances coexist, which reinforce one another: the restructuring of the state-owned sector, the risk of insolvency of banks and the rising demand for social welfare. The state sector has withdrawn significantly from many parts of the economy in terms of numbers of SOEs and employees. Important progress has also been made in the restructuring of the state-owned sector: overall productivity has improved, although it is still less than in the private sector (OECD, 2005). But a significant core of distressed state-held companies with financial problems (7% of firms, 11% of workers, 23% of assets and 22% of outstanding debt) remains at all administrative levels. These include companies with negative equity, negative value added, or sub-zero rates of return on assets. Increasing competition resulting from the rising prevalence of market prices in both upstream and downstream markets combined with the growth of the non-state sector means that less efficient state enterprises face increasing financial difficulties. Growing budgetary pressures on local governments (*cf. infra*) have meant that loss-makers increasingly cannot be subsidized.

At the same time, restructuring or withdrawing from loss-making public enterprises reveals their insolvency. Indeed, while analysis of debt associated with distressed firms shows that the burdens have declined over time, a substantial number of firms hold debt that is, or is likely to become, non-performing. And, in spite of progress being made, much remains to be done before the banking sector, and in particular the state-owned commercial banks and rural credit co-operatives, can be said to be financially healthy.

Restructuring of the state sector also implies laying off workers. Employment in state-controlled industrial companies fell by almost 40% from 1998 to 2003, as close to 30 million workers by official estimation were laid off. This is a major source of social tensions, partially eased by the introduction of an urban minimum living standard for laid-off urban employees in 1997, which represents increasing costs for local government. More broadly, a government-based social insurance system comprising pension, health, unemployment, injury and maternity was established in 1997. Prior to this date, benefits were provided by the companies to employees. The costs of this shift of responsibility for the provision of social services from productive units to local governments also took place in former communist countries such as Poland and the corresponding costs were widely underestimated.

In addition, an increasing number of protests and demonstrations of various forms reflect growing social discontent. There are multiple causes, including unemployment, growing individual, regional and rural/urban economic inequalities, increasing demand for services from an ageing population and corruption or abuse of power. Another source of social protest are the important environmental deteriorations brought by rapid economic development, which have created large numbers of ecological migrants. To give examples, acid rain is falling on one-third of the Chinese territory, one-third of the urban population is breathing polluted air, and less than 20% of the trash in cities is treated and processed in an environmentally sustainable manner.

These interlinked problems create a particularly difficult situation for reform. Many actors (loss-making SOEs, banks with negative capital that survive only through regulatory forbearance, governments, employees) have a short-term interest in the *status quo*. But the *status quo* is unsustainable. Reform is all the more important as the weak financial environment is limiting the potential development of the private sector – and thus the creation of jobs. Also, public resources that could be used to finance social services are absorbed to subsidise non-performing loans.

The recently adopted Scientific Development Concept (*kexue fazhan guan*) and the Harmonious Society (*hexie shehui*) concept take on a more comprehensive approach towards development (cf. Box 0.1). They complement the discourse about the Chinese modernization path with a social dimension and stress the need to reconcile conflicts between rural and urban areas and between different social groups to promote social stability. The evolution of the political discourse shows a raising awareness regarding the importance of governance among Chinese leaders.<sup>5</sup>

Four broad areas appear to require further reform efforts:

1. Pursue the redefinition of the **role of the state**, and address the consequent organisational challenges this evolution raises. This question precedes that of the sustainability of public expenditures and of efficiency of public action.
2. Modernise the **governing tools** (regulatory framework, budgeting, civil service) and adapt these to a market-driven economy. This is necessary to improve the efficiency and effectiveness with which public resources are used. Strengthening the rule of law and regulatory stability will provide citizens and businesses with greater confidence concerning state institutions. This is also crucial to strengthen the state capacity and non-state mechanisms to arbitrate between conflicting interests, and between short-term and long-term objectives.
3. Adjust the **relations between levels of government**. This vertical dimension of the system of governance is crucial in many respects: to handle the remaining difficulties of the transition process, but also to provide better public services for citizens and enterprises. This comprises both fiscal and administrative aspects.
4. Consolidate the **institutional framework for market forces**. This is a necessary condition to strengthen the role of the private sector both as an engine of economic growth and as a provider of basic services.

The following four parts of this synthesis gather results of the China Governance Project on these four topics. A final part summarises the conclusions.

## 2. Evolution of the role of the state and subsequent organisational challenges

The transition process has implied an evolution of the role of the state, reflected in changes in the structure of public expenditures as well as in the organisational architecture of the public administration. The state has taken on a new role in relation to production and service units, from which the state is not retrieving totally. This evolution required the setting up of new institutions (to regulate SOEs and the financial sector) and new modes of functioning, both in regulation and service delivery. Drawing on several chapters, this part reflects the progress made on these issues.

### 2.1. Public spending: narrowing scope and changing priorities

Chapter 8 analyses the evolution of the structure of on-budget public expenditure since 1997. It concludes that the structure of public expenditure appears out of line with China's development needs and goals in three respects. Public spending on education is too low, not reaching the target of 4% of GDP fixed by the government. Spending on science and technology is also relatively low. Building a national system of innovation is crucial at this stage of development, to support technological upgrading. Finally, public spending on health is too low. The entry of private capital in the health sector alone is unlikely to meet the increasing needs for healthcare services. These expenditure gaps affect both economic growth and social cohesion.

At the same time, there is growing pressure for spending on social welfare (health but also pensions and unemployment/social relief). The pressure on public spending has been partially alleviated by increased revenues, thanks to economic growth and to the reform of the tax system, and to improved collection and compliance. However, as in most developing countries, informality and low productivity make it difficult to collect income tax and social insurance contributions outside the developed parts of the urban economy, comprising barely one-fifth of all employed persons (cf. Chapter 11). While this can put pressure on the authorities to rely on other revenue sources, such as consumption taxes, recent decisions to abolish various rural taxes and fees suggest that the government may see little room for additional taxation of any form in rural areas in the near future.

Although many recent reform efforts have been designed to improve the targeting and so increase the efficiency of public spending, there is still a need to consider fundamental questions about the role of the state. This is relevant at two levels: at a macro-, strategic level, i.e. setting priorities, in a perspective of macroeconomic regulation of growth and income distribution; and within each category of expenditure, assessing which activities or parts of activities should be left to the private sector, should be financed partially by users, etc.

The share of public spending allocated to investment is well above the OECD average; only Korea presents a higher share. Part of the investment spending has been motivated and justified by the government's policy of promoting development in Western regions (the so-called *xibu kaifa* policy). Investment has also been undertaken by provincial leaders in order to maintain the growth rate locally. These investment decisions have contributed to the overheating of the Chinese economy observed at the beginning of 2004.

Spending is also still high on public sector administration. Successive attempts to reduce the number of public sector employees have not been very effective. It is indeed not easy to cut the public labour force, since in the poorer areas, public sector employment functions as a social safety net.

## **2.2. New institutions to frame the state's participation in economic sectors are needed**

The Chinese state will remain active, if not dominant, in a number of sectors. Important steps have been taken to change the governance framework of this participation, with in particular the creation of several regulatory bodies. But further efforts are needed to improve this new mode of state participation in economic sectors. Efforts to fine-tune the functioning and role of these new regulatory bodies should also be accompanied by measures to improve the internal governance regime of regulated entities (cf. Chapter 10 and Section 3) and by measures fostering competition and market scrutiny.

As competition in the economy is increasing, loss-making SOEs are creating unaffordable financial liabilities and inadequate services are affecting economic development overall; thus, improving the management of state-owned assets has become a top priority area for the current government. Chapter 10 recalls the different phases of the reform of SOEs and analyses in particular the impact of the creation of the State-owned Assets Supervision and Administration Commission (SASAC) in 2003. The fundamental objective behind the creation of SASAC has been to “fulfil the functional responsibilities of capital investors”, implying a clear separation of ownership from management, a focus on investment returns and the use of legal means and mechanisms for shareholder intervention. But Chapter 10 shows why the reform effort does not yet allow for fully effective management of state-owned assets. The transition to a more efficient system of control would imply a number of supplementary measures, including: i) the creation and enhancement of the role of boards in SOEs, and the improvement of recruitment and performance evaluation procedures for their senior management; and ii) strictly separating the government's exercise of its ownership in SOEs from its regulatory and other functions and eliminating interference in SOE management.

Another important evolution has been that of the governance framework of financial institutions. In order to avoid destabilising systemic crises, to reduce the size of the future bail-out of failed institutions and to enable the financial system to allocate resources to the real economy, significant changes are necessary. In the banking sector, it has become clear that injecting funds into the banks will not help repair their balance sheets if the basic framework under which they operate is not reformed. As described in Chapter 13, the China Banking Regulatory Commission (CBRC) was created in 2003 to assume the responsibility of banking supervision from the People's Bank of China, in order to separate supervisory functions from that of monetary policy. Other financial regulatory commissions created earlier, the China Securities Regulatory Commission (CSRC, 1992) and the China Insurance Regulatory Commission (CIRC, 1998), have been given enhanced powers and have been steadily upgrading their capabilities.

At different rates from one sector to the other, institutional reforms have also taken place in the public utilities sector. The State Electricity Regulatory Commission (SERC) was set up recently to promote the development of a regional electricity market. As for other network industries (cf. Chapter 9), their reform has accelerated since the late 1990s, in response to rapidly increasing demand and to fulfil WTO commitments. Yet in the sectors of gas, rail and to a lesser extent telecommunication, reforms have still not significantly modified the institutional framework in place.

Although important steps have been taken in the right direction (cf. Chapters 9, 10 and 13), remaining problems call for sustained and co-ordinated reform efforts. To take one example, despite the creation of the CBRC and substantial official efforts to improve credit quality,

the 2003 credit boom suggests that borrowing and lending decisions are still not fully made on the basis of strict commercial criteria. The chapters highlight several issues concerning the relations between state regulatory bodies, government authorities and the regulated entities.

A primary issue is to ensure that regulatory bodies are “distant enough”, that is sufficiently independent, from the entities they regulate. Regulatory authorities necessarily need to have regular information and communication with the businesses subject to their authority if they are to effectively perform their functions. Yet too close a relation can result in the regulated using the regulator (“regulatory capture”) to establish monopoly positions or otherwise inhibit competition.

A second issue is to maintain the right distance between government authorities and regulatory bodies. This is particularly relevant in the case of the oversight of SOEs, as there is a need to clearly separate the objectives and strategy assigned to companies by the state, as a majority shareholder, from its regulatory and other functions and from the management of these companies. As described in Chapter 10, the creation of SASAC has clearly contributed to shift the objective of supervision from direct intervention in enterprise management to capital oversight. However, SASAC continues to be responsible for the nomination, assessment and dismissal of not only the CEO but also of senior executives in those state-owned assets that have not yet been incorporated. Therefore it is likely that state interference in those companies’ operations will continue to take place. If, where existing, boards in SOEs may not be in a position to take on these functions immediately, the procedures through which top management will be recruited and assessed should at least be transparent and based on criteria of relevant business competencies.

A third issue is to clarify and consolidate the accountability relationship between the government authorities and the regulatory actors. If the process of “controlling the controllers” is transparent, it helps avoid undue interference. The accountability of the regulatory bodies, rather than just their reporting lines, needs to be clearly defined.

Finally, it is also important to clearly identify the division of responsibilities between the different regulatory bodies. Clarifying the division of responsibilities between the SASAC and the CSRC, and their link with upstream authorities, are of particular importance to allow for adjudication, as for instance, at the time of initial public share offering on capital markets, these may have diverging interests. A transparent division of responsibilities between the CSRC, the stock exchanges and other self-regulating organisations is also crucial as it is a precondition for improving the efficiency and effectiveness of administrative enforcement.

### **2.3. The reform of public service units is a pressing issue**

Under the pre-reform regime, public service units (PSUs) were all owned and managed by the government, receiving funds from the budget to finance all their operations. Their activities were conducted according to the state plan, insulated from any competition mechanism. In order to respond as much as possible to a growing demand with insufficient public funding, past reform measures have led to a substantial modification of the institutional status of PSUs, increasing their flexibility and autonomy in terms of financing, accounting, staffing and management practices. To find alternative sources of financing, a PSU would then either commercialise some of the services delivered or develop in parallel commercial activities with no direct link with the initial purpose of the PSU. Also, to make up for the insufficiency of services delivered, private companies have been authorised to develop in some of the sectors of activity of the PSUs.

After a series of piecemeal reforms, often implemented sector by sector, the Chinese Government is currently embarking on an important reform of PSUs. The stakes of such a reform are considerable, as the 1.3 million PSUs employ 25.5 million people. The problem is multi-dimensional: financial, organisational, managerial and regulatory.

The chapter on higher education gives a good illustration of the increasingly complex situation that has developed around PSUs, describing the evolution of the financing and of the organisational forms in this sector. In the past two decades, higher education institutions (HEIs) and the higher education sector in general underwent a radical transformation. HEIs used to be affiliated with ministries at the central level, but 85% of them were subsequently decentralised to provincial or sub-provincial level. HEIs were encouraged to find alternative sources of financing as the central and the local budgets could not finance the expansion of the sector that was needed. As a result, there are four sources of financing today: central budget (even for HEIs affiliated to sub-national governments), sub-national budgets, students' tuitions and fees and private sector contracts. Only 50% of the total budget of HEIs is covered by public funds.

This increased flexibility and opening of the higher education sector has allowed a rapid increase in both the volume of higher education and its quality. The number of students has increased by a multiple of 15 within 10 years, and private capital has allowed the modernisation and renovation of HEIs. On the other hand, relying heavily on private sources for financing tends to increase social and territorial disparities, in particular as long as the loan schemes that have been introduced do not function very well. Higher education becomes accessible only to those who can afford it. In addition, it is not uncommon that professors combine working in public HEI with teaching in private HEIs or prefer to spend time working on lucrative contracts (with the private sector but also with international or foreign agencies), to the detriment of basic teaching assignments or support to students. Third, the management of resources coming from private sources is not always transparent or done to serve the public interest. As a result, quality is uneven and difficult to monitor. Finally, the development of other sources of financing has not always been accompanied by efforts to increase the efficiency and performance of the HEIs.

The reform of PSUs today is driven by three issues: i) the need to clarify what should be the role of the state in the different sectors of operation of PSUs; ii) the need to improve the performance of PSUs; and iii) the need to clarify the management and accountability of PSUs to ensure they serve the public and not themselves.

Chapters 2, 17 and 18 discuss possible reform approaches. The question of what should be the best organisational form for PSUs, and thus of the role of the state, should not only be guided by fiscal considerations and related issues of equity (who should pay for what), and considerations of efficiency (including the necessity to introduce some degree of flexibility in formulating public actions in order to take local factors into account). Decisions on the organisational form should also take into account the broader organisational and management context in which public action will take place. The increase in autonomy and flexibility that PSUs have known does not mean that the government and line ministries should play no role at all – but rather calls for an evolution of that role. In the context of the PSU reform, it is important that measures be taken to strengthen the accountability relationship between those PSUs that will keep their independent agency-like type of status and the government body to which they are affiliated. If the operating context does not allow for the formal arrangements to be put in place efficiently, it might be wiser to promote integration into line ministries.

## 2.4. Half-way organisational changes create huge challenges of co-ordination

A multitude of successive sector-specific and administration-wide reforms have contributed to modifications of the organisational structure of the Chinese administration. However, many chapters in this report refer to organisational and co-ordination problems, which are linked to the co-existence of structures inherited from the past with new institutions. Five types of issues were detected in the policy areas covered by this report: i) lack of co-ordination between closely related organisations, leading to efficiency losses (e.g. budget, intellectual property rights); ii) lack of co-ordination between organisations with overlapping mandates, affecting the coherence of public action (e.g. water, statistics or agriculture); iii) hierarchical structure between organisations not corresponding to their mandates (e.g. FDI policy); iv) fragmentation of decision-making responsibilities (e.g. public expenditure); v) co-existence of institutions with conflicting working rationale/mandates (planned-economy versus market-based; e.g. agricultural policies).

An example illustrating the fragmentation of decision-making responsibilities in a complex institutional framework is the management of public expenditure. Even if the role of the economic and social development plans has changed, the NDRC continues to be the body co-ordinating their design and implementation. Decisions related to capital expenditures continue to be the responsibility of NDRC, while the budget, managed by the Ministry of Finance, covers only recurrent expenditures. Capital spending decisions are not required to be co-ordinated with fiscal authorities, even when these decisions will create large recurrent costs downstream. Similarly, staffing decisions, which have major spending implications, are made by the State Commission Office for Public Sector Reform (SCOPSR) and its local branches, with little consultation with fiscal authorities.

This fragmentation of decision-making responsibilities not only creates co-ordination difficulties but also affects the “readability” of public policy. Integrating all decisions related to public expenditure would allow better control and would better ensure fiscal sustainability. Moreover, it is not clear who will be the final guarantor of fiscal balance in China. Currently, this outcome will inevitably depend more on the balance of power between the different institutions than on policy choices.

An example of co-existing institutions with conflicting working rationale/mandates is detailed in the chapter on the institutional framework of agricultural policies. Despite important strides made in the 2003 reform, a complex Web of 14 ministries and commissions are still directly involved in governing agriculture and its upstream and downstream sectors. The introduction of measures towards the liberalisation of production, pricing and marketing has led to the creation of new institutions or to the redefinition of the mandate of old ones. At the same time, the production and trading of commodities considered of strategic importance, such as staple foods, have continued to be managed through state-linked enterprises. Institutions still carrying characteristics of the planned economy co-exist with institutions charged with the implementation of policy measures based on market principles.

In such a complex and highly fragmented institutional framework, with conflicting mandates, it is difficult to create incentives for co-operation and co-ordination among state actors (cf. in Chapter 16 the example of the grain sector). Therefore, further efforts are needed to streamline the organisational structure for the design and implementation of agricultural policies. But this organisational reform should be guided by redefining the role of the state in agricultural policy. The focus of public action should increasingly be on services that will



increase the competitiveness of farms and rural enterprises and that will facilitate the restructuring process. Accession to WTO and the resulting opening to foreign competition make the need for restructuring and the improvement of efficiency even more pressing.

### 3. Modernising governing tools to improve the efficiency and the effectiveness of public action

Drawing again on several chapters of this study, this part gathers the results related to the need to modernise the governing tools (regulatory framework and public management) and adapt these to a market-driven economy. As mentioned previously, this is necessary to improve the efficiency and effectiveness with which public resources are used.

#### 3.1. From control to regulatory governance

China has taken a series of steps to improve the regulatory capacity of the government, the regulatory framework and to strengthen the rule of law (cf. Chapter 9). For instance, the 2000 Legislation Law has clarified the role of the National People's Congress (NPC) and of the State Council in the law-making process, thus increasing its transparency and coherency. In many respects, as for example concerning intellectual property rights or individual employment contracts, China has adopted regulations that are well in line with international standards, but their enforcement has become a major challenge (cf. Chapters 14 and 11). In other areas there are still many traces of the previous planning system, resulting often in an overly complex and incoherent regulatory framework (see for instance Chapters 5 and 16, and Section 2.4). Several chapters point to the lack of secondary-level regulations or to their poor quality. Regulatory coherence is a significant problem. The National People's Congress and the State Council normally play a supervising role, but the large volume of sub-national legislation makes this task difficult to achieve.

Strengthening the rule of law and the regulatory framework will provide citizens and businesses with greater confidence concerning state institutions' evolution of the devices through which power is exercised. This is also crucial to strengthen the state capacity and non-state mechanisms to arbitrate between conflicting interests, and between short-term and long-term objectives. The following paragraphs summarise findings related to two aspects of the ongoing transition from control to regulatory governance: i) the reform of the administrative approval system and more generally, the evolution of the relationship between the state and non-state actors; and ii) the problem of application and enforcement of regulations.

##### 3.1.1. Reform of the administrative approval system

Until recently, state control on economic activities through administrative approvals had continued to be an important characteristic of the Chinese economy. This was a legacy from the planned system, in which state controls penetrated virtually all sectors of economic life – from access to raw materials to price setting to distribution and sales. In its transition to a “socialist market economy”, China is taking important steps in order to reduce restrictions on enterprises' ability to enter and exit the market, or otherwise respond efficiently to consumer demand, in particular with the reform of the administrative approval process.

In recent years, the reform of administrative approvals has become a high priority of the Chinese Government, as reflected by the creation of the Leading Group for Administrative and Examination Approval System Reform in 2001. Important reform

measures have been taken recently (cf. Chapter 9), with the adoption of the Plan for Administrative Approval System Reform and of the 2003 Administrative Licensing Law (which covers a significant subset of the items subject to administrative approval, those primarily relating to business activities). The related Administrative Approval Reviews have led to the elimination of 1 795 approval requirements at the central level, out of a total of more than 4 000. The Licensing Law narrows the scope of activities for which a licence is required, and even in cases where a licence is required, it encourages self-regulation. This law should make the licensing process less burdensome, more open and less subject to delay. Some regulatory barriers to market entry will continue to exist, but will need to have a stronger connection to the several concepts of public interest specified in the Law. As noted in Chapter 9, it is too early to assess the impact of this law, but the significant efforts made to guide public bodies and civil servants for its implementation indicate a high level of political will.

In parallel, in July 2004, the State Council issued the Decision Concerning the Reform of the Investment System to streamline the investment approval process (cf. Chapter 15). This Decision simplifies the process through a single application report, and mandates a greater delegation of approval powers to local authorities. The revised Catalogue for Guidance of Foreign Investment adopted in February 2002 also represents a major step forward in foreign direct investment regime liberalisation. In view of the experience of OECD member countries, the Chinese Government, if it wishes to attract more and better foreign investment, may consider replacing the catalogue, which lists prohibited, restricted and encouraged categories, with a single list of sectors barred to foreign participation.

In the labour market, an important step was taken in 2003 with the elimination of administrative controls on the recruitment of migrant workers. As discussed in Chapter 11, this has not led to equal treatment of urban and rural workers in all respects, but it means that employers are free to hire the workers they want, and job seekers are free to compete for jobs anywhere in the country.

In relation to these issues, two important messages emerge from the different chapters of this report.

First, in spite of the overall liberalisation trend, many activities continue to be subject to a large amount of government control. This is the case for instance with grain production, pricing, marketing and distribution and also with the land tenure system (cf. Chapter 16). The Chinese state should aim to further reduce its intervention, shifting the emphasis from planning activities to enabling activities, providing services and infrastructure. This is valid at the national level but also at the local level, since the experience of OECD member countries shows that policies to improve the business environment are key to local development. In the context of agriculture, allowing farmers, rural citizens and agro-rural enterprises to make their own decisions is likely to increase the efficiency of the allocation of resources. More generally, Chinese leaders should let investors determine which investment will be profitable and which will not, and bear associated risks. In addition, to the benefit of the Chinese people, this evolution could also allow to shift the state focus further toward regulation with respect to the protection of public health and safety, away from restrictions on competition.

As stressed in Chapter 16, such evolution of the government's role implies a profound shift in mentalities and in the relations between state and non-state actors: from a top-down hierarchical approach, implementation through direct control and objectives

formulated as outputs and capital targets, to one that is service- and needs-oriented, responsive and accountable, servicing the needs of citizens and economic actors, setting up appropriate incentive systems and creating circumstances that allow winners to emerge. It also implies a change in competencies for mid-level managers, who have to learn to operate in a very different environment. This dimension of the transition should not be overlooked by Chinese leaders, and in this regard, opportunities for exchange with foreign officials and experts could be helpful.

Second, efforts made to streamline the regulatory framework of private businesses should be pushed further. Indeed, the operating environment for businesses continues to be quite complex, creating opportunities for extortion and bribery. In some cases, successive piecemeal reforms have added to the complexity of the regulatory framework. As noted above, recent efforts will certainly contribute to the improvement of the regulatory environment. As described in Chapter 6, China has also simplified the administrative regulations in the area of taxation, introducing one-stop shops and simplifying procedures for permits and licenses and by putting time limits on decision-making. Although commendable, there is still a long way to go. The costs born by enterprises linked to the complex administrative environment affect the profitability of domestic and foreign investments in China. Again the experience of OECD member countries with reducing administrative and regulatory burdens on enterprises could be pertinent for China.

### 3.1.2. Enforcement

The main challenge concerning the regulatory framework is that of application and enforcement of regulations; as described throughout the report, the application of laws and regulations is not always systematic, sometimes biased by corrupt arrangements or reflecting the local balance of interests.

The solution to problems of enforcement will probably not lie in occasional enforcement campaigns as are regularly organised in different fields, including anti-corruption, intellectual property rights or environment protection. These campaigns remind economic actors of the existence of the laws and correct a few misdeeds, but in the end they have little effect on behaviour patterns.

Part of the solution lies in strengthening the inspection bodies and the administrative and judicial enforcement bodies. Under the regime prior to the economic reforms, officials were under the close scrutiny of their supervisors. Organisations had cumbersome book-keeping procedures, but there were few agencies or effective procedures to control the overall functioning of public entities. Today, China needs to strengthen formal systems of financial and performance audit. Chapter 9 mentions the problem of inspectors being dependent on the local level, leading to poor enforcement (further discussed in Section 4).

As for judicial enforcement, trained judges are short in supply, in particular in less developed areas (see Chapter 10). Some chapters (for instance Chapter 15) point to other inadequacies of the court system, such as judicial ignorance of the law, corruption within the judicial system, pressures on judges from local government and CPC officials and inability of courts to enforce their own decisions. Chapter 17 on environment explains that courts tend to decide on the cases by relying on Party policy, the views of the local government and a court's individual sense of justice and fairness in contractual dealings. Factors such as *guanxi* (social connections) between Environmental Protection Bureau (EPB)

staff and enterprise managers, interventions by local officials, and an enterprise's profitability often lead to outcomes that are far from those specified in environmental regulations. Chapter 14 points to the difficulty of launching a criminal lawsuit and to the fact that civil and administrative sanctions are not strong enough to dissuade infringers.

But the focus should not only be on strengthening the bodies involved in enforcement. Section 4 exposes the impact of the dysfunctional managerial and fiscal relations across levels of government on the enforcement problem. More fundamentally, regulatory governance implies a paradigm shift in which application and enforcement of regulations are based primarily on voluntary compliance. The deterrent effect of possible sanctions is only one element that contributes to create attitudes of compliance. Other elements relate to the quality of regulations, the regulatory-making process, public participation in this process, public participation in the application and enforcement of regulations, and thus the overall context of access to information. Indeed, the problem of regulatory enforcement is not just a technical problem. It rather reflects limited acceptance of new rules of the game and consequent tensions between interests of various groups. In other terms, the "regulatory enforcement problem" also reflects underlying dynamics of social change. Solving it will necessarily imply increasing public participation.

The nature of the political regime necessarily places constraints on possible progress in the areas of public participation and access to information. Special interest groups such as business, workers or farmers are generally prevented from forming associations outside the control of political leaders. There is still a lack of involvement of constituencies and stakeholders in policy-making and implementation. Chapter 15 for instance shows that while the Chinese Government has in recent years started to involve foreign companies in consultations leading to the promulgation of legislation related to foreign-investment, this process appears to be inconsistent and incomplete. Similarly, Chapter 14 explains that Chinese enterprises and other institutions have complained that relevant intellectual property authorities did not extensively solicit opinions and comments when compiling laws, regulations and policies. This insufficient consultation has led in some cases to inadequate protection standards.

In some areas, Chinese leaders have understood that pressure from public opinion usefully complements enforcement efforts. For instance, Chapter 17 shows that the SEPA has become interested in public disclosure because China's pollution problem remains severe, despite long-lasting attempts to control it with traditional regulatory instruments. Various tools and mechanisms are being used to inform and consult citizens, and to involve their participation: public hearings, advisory committees, document reviews, informational meetings, forums and Environmental Impact Assessments (official process of analysis of the anticipated effects of planned projects or activities on regional and local areas).

Another case in point is the labour law's provisions about working time and other working conditions (Chapter 11). Such rules are generally difficult to enforce when labour supplies are abundant, a situation that gives most job-seekers a weak bargaining position. Nevertheless, recent developments have suggested that a growing awareness of the importance of working conditions can make many job-seekers more demanding, and so put market pressure on employers to improve these conditions.

Although the media continue to be controlled by the state and there is limited freedom of expression and of association, positive steps can nevertheless be observed related to access to information, in part linked to the WTO accession process which requires

increased transparency in public affairs. Several chapters note that information on rules, regulations and projects and their implementation by officials has become much more accessible in recent years. This trend has sometimes been reflected in the legal framework, as the obligation to provide information to citizens has been integrated in several sectoral laws. The Administrative Procedures Act mandates increased transparency in a wide variety of public policy areas. Progress is uneven at the local level. For instance, it seems that many local authorities are reluctant to provide copies of their local rules or regulations regarding intellectual property rights (IPR) as well as any local enforcement decisions. The Chinese Government argues that the provision of requested information is in itself a huge task, given the quantity of legislation.

### **3.2. Public management**

The following paragraphs review the main results of the study on the two principal pillars of public management: the budget and the civil service. The potential benefits of the introduction of e-government and the need to simplify and rationalise administrative procedures are then discussed. In spite of progress made on all these fronts, corruption continues to be a major problem in China, symptomatic of the weaknesses of the public management environment. The analysis of these different elements of public management in China shows that progress varies from one region to another, in particular in improving the quality of the civil service. It also shows the interdependences of the different reform efforts, between budget and civil service, in particular in a perspective of managing performance; between e-government and administrative reforms. All these reforms, complementary to a repressive anti-corruption policy, are fundamental to curb the widespread problem of corruption.

#### **3.2.1. The budget**

Chapter 7 describes the reforms introduced since 1999 in budget management, from budget preparation with the introduction of departmental budgets to budget implementation. China appears to be, step-by-step, putting in place the infrastructure necessary for building a modern system of budget management. However, the budget management system remains marred by several weaknesses, impeding it from becoming a fully effective tool for policy management and implementation.

On-budget public expenditure represents only 20.3% of GDP in 2004. This is the part of the funds that can be discussed and allocated in a place where pros and cons are discussed and evaluated, above and beyond direct or local interests. Extra-budgetary revenues and expenditures (fees and levies collected by branches of government and spent off budget, tax expenditures, payment arrears, etc.) remain large, estimated to represent 10% of GDP in 1998. There are on-going efforts to move extra-budget activities onto the budget.

As mentioned before, the Ministry of Finance still does not have comprehensive oversight authority on spending. Co-ordination between central and local governments is improving but remains weak, and revenue forecasting also remains weak. In part due to the fiscal gaps described previously, improvement of budgeting at sub-national levels is limited. And finally, compliance with existing laws and regulations needs strengthening.

In the reform process, the government has focused mainly on tackling the technical issues, and has shied away from reforms that more directly involve political challenges. In particular, there has been little public discussion of the need for a major realignment of the intergovernmental fiscal system in spite of the many changes underway since 2000, as a

result of reforms in the rural sector. Other important and needed steps include the refocusing of budget priorities and limiting policy initiatives which are not disciplined by the budget process in order to improve orderly prioritization. Finally, the recent audit reports of the State Audit Administration highlight the many difficulties government faces in enforcement of fiscal discipline and in holding spending units accountable for results. Strengthening accountability mechanisms and enforcing aggregate fiscal discipline constitute the critical next challenges for reforms in the next phase.

### **3.2.2. The civil service**

The Chinese Government has undertaken extensive reforms to its civil service system over the past 10 years. Chapter 1 discusses these reforms and analyses remaining challenges.

In this field as in others, a first problem is to ensure that the rules – in relation to recruitment, reward, promotion, etc. – are applied. For instance, not all recruitments go through the established mechanisms. This gap between rules and practice is particularly important in less developed regions, where the public sector plays a role of employer of last resort.

Another important challenge for the Chinese civil service is its high geographical heterogeneity. In the centre and in the richer coastal areas, civil service is relatively performance-oriented, selects “the best and brightest” through competitive mechanisms, links rewards to performance, and controls indiscipline and corruption. In the less developed hinterland, civil service operates as an employer of last resort and presents relatively high levels of indiscipline and corruption. Improving the systems in these poorer areas depends on improving levels of economic development, which in turn is most likely with a competent and committed bureaucracy. Intervening to break out of the vicious circle linking underdevelopment and inefficient bureaucracy is an important task for the foreseeable future. Chapter 1 discusses possible measures, such as transfers of experienced officials to poor areas or flexible pay scales.

### **3.2.3. Administrative simplification and e-government**

Several chapters note the complexity of procedures and regulations and thus stress the potential benefits of further administrative simplification. For instance, the current organisational structure of the tax administration based both on “type of tax” and “function” could be flattened and streamlined through centralizing and merging replicated and overlapping functions. Also, a simplification of regulations could lead to a substantial reduction of compliance cost for taxpayers and of administrative cost for tax authorities.

Such administrative simplification reforms are necessary to increase effectiveness in the adoption of information and communication technologies (ICT). Chapter 6 notes the importance of developing a unified information and technology system to integrate the varied functions of tax collection and administration. More broadly, Chapter 4 depicts the promotion of e-government adopted by the Chinese leadership. It shows that e-government initiatives are moving from simply encouraging the adoption of ICT to promoting substantive reform in the public sector.

But the success of e-government programmes is contingent upon progress in other fronts: administrative reforms that seek to standardise operational procedures and clarify responsibilities, strengthening of the rule of law for instance. These issues in turn involve