

China in the Global Economy



# Governance in China



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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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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.

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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.