

# **DEVELOPMENT MANAGEMENT**

Progress and Challenges in the  
People's Republic of China

**ASIAN DEVELOPMENT BANK**

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## CURRENCY EQUIVALENTS

(as of 30 November 2002)

Currency Unit	–	Yuan (CNY)
CNY1.00	=	\$0.1208
\$1.00	=	CNY8.2771

On 1 January 1994, the dual exchange rate system of the People's Republic of China was unified. The exchange rate of the yuan is now determined under a managed floating exchange rate system.

## ABBREVIATIONS

ADB	–	Asian Development Bank
CICPA	–	Chinese Institute of Certified Public Accountants
CPA	–	certified public accountant
CPC	–	Communist Party of China
GDP	–	gross domestic product
MOF	–	Ministry of Finance
MOFTEC	–	Ministry of Foreign Trade and Economic Cooperation
NBS	–	National Bureau of Statistics
NGO	–	nongovernment organization
NPC	–	National People's Congress
PRC	–	People's Republic of China
SAT	–	State Administration of Taxation
SDPC	–	State Development Planning Commission
SETC	–	State Economic and Trade Commission
SME	–	small and medium enterprise
SOE	–	state-owned enterprise
UNDP	–	United Nations Development Programme
VAT	–	value-added tax
WTO	–	World Trade Organization

## FOREWORD

The People's Republic of China's (PRC) transition to a market economy has put extraordinary demands on the Government to change the fiscal, policy, and regulatory environment into one that is appropriate for managing a modern market economy. Over the past decade the Government has made rapid progress in developing an economic management framework with modern institutions and practices. A series of reforms have improved public administration by reducing the Government's role, increasing the private sector's role, decentralizing power, and making use of market forces to improve productivity and efficiency.

The Asian Development Bank (ADB) has established governance as one of the three pillars of its Poverty Reduction Strategy. ADB's 1995 *Governance: Sound Development Management* policy argued that without good governance, efforts to reduce poverty would not be effective. To address poverty, a country must have a basic foundation of capable institutions and sound governance practices, leading to effective markets.

ADB's governance policy focuses on four principles: transparency of operations, accountability, predictability, and participation. The report recognizes that the PRC has made genuine efforts to improve in many of these areas. I hope that this work will contribute to a better understanding of governance issues and provide concrete direction for action by the PRC. I also hope that it will be a basis for dialogue about further reforms that are needed; priorities and steps to be taken; and accountability for results. If this will result in a greater commitment to better governance, the report will have achieved its purpose.

This report was prepared by a team of ADB staff and international and PRC consultants under the overall direction of the East and Central Asia Department and supported by ADB's PRC Resident Mission. The work was led and supervised by Marilyn Collette, Governance Specialist.

Without the support of the Ministry of Finance, this assessment would not have been possible. This support is gratefully acknowledged and I wish to thank all those who have so generously contributed their knowledge and insights.

Geert van der Linden  
Director General  
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The ADB team comprised Marilyn Collette, Governance Specialist, from the East and Central Asia Department (Governance, Finance and Trade Division), who led and administered the work; Min Tang, Principal Economist; and Peng Longyun, Economist from the PRC Resident Mission. The study team received valuable support, insights, and guidance at various stages of the work from Mme. Zhang Yuejiao, former Deputy Director of Programs East Department, Shamshad Akhtar, Director of Governance, Finance and Trade Division of the East and Central Asia Department; and Bruce Murray, PRC Country Director at the Resident Mission in Beijing. The assistance of Alice Faintich in editing and of Aileen Aguilar and Chona Murakami in production is acknowledged with thanks.

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The team wishes to thank colleagues in the PRC at all levels of government and society and representatives from the international development community who contributed their insights. The report has benefited greatly from their comments and suggestions.

## BACKGROUND

The Asian Development Bank (ADB)'s Policy on *Governance: Sound Development Management* defines governance as the "manner in which power is exercised in the management of a country's social and economic resources for development."

Studies such as this one, are being undertaken in many countries to respond to ADB's overarching goal of poverty reduction by identifying (i) the improvements to the enabling environment required for effective markets and economic growth, and (ii) the structures and systems that are contributing to poverty reduction and the needs for strengthening and improving them. These studies recognize that the quality of governance has a direct and indirect bearing on increased economic growth, improved systems for human development and access of the poor to social assets. ADB has completed country governance assessments (CGAs) in many DMCs, including Bhutan, Cambodia, Lao People's Democratic Republic (Lao PDR), Thailand, and Viet Nam. CGAs that are in process include those for Bangladesh, Fiji, India, Indonesia, Kazakhstan, Kyrgyz Republic, Federated States of Micronesia, Mongolia, Nepal, Pakistan, Papua New Guinea, Philippines, Samoa, Sri Lanka, Tonga and Vanuatu.

In 2001, ADB began working on this report to assess the PRC's economic development management systems, to document progress made, and identify areas where further progress is needed, if the Government's programs and ongoing reforms are to be optimized. The specific objectives of the assessment were (i) to gain a better understanding by taking stock of the reforms to date, (ii) to identify priority issues that need to be addressed, and (iii) to use the assessment as a foundation element underpinning ADB's new Country Strategy and Program 2003-2007 to define the best role for ADB in this area over 5 years.

The report aims to analyze the PRC's development management in the economic context and legal framework where reforms are taking place. It includes an analysis of the changing role of government in moving from a central planning to a market-based economy, and from a command and control approach to public sector management, to a more market-oriented system.

The report combines three methodologies incorporating (i) information from recent documents, books, and articles on the PRC, including ADB technical assistance reports involving significant development management activities; (ii) information derived from in-country interviews and participatory seminars and workshops with key stakeholders; and (iii) description and analysis of sound development management components and strategic areas of interest to ADB and to the PRC. The report concludes with an action plan for the Government, for the development community, and ADB to address areas where more progress is needed.

The approach to the report was participatory and involved consultations with more than 150 representatives from 25 government agencies and with over 100 representatives from the private sector and civil society, including staff of universities, think tanks, research institutions, and nonprofit organizations. Representatives from the most active international development partners in the PRC were also contacted to survey their work and take into account their opinions and commitments.

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## EXECUTIVE SUMMARY

The fundamental development management challenge facing the Government of the People's Republic of China (PRC) is to implement reforms of the state structure so that it is appropriate for a market economy, while at the same time maintaining both economic growth and social stability. Economic growth is a prerequisite for the PRC to substantively achieve its goal of reducing poverty. Both the State and society play key roles in this goal.

The role of the State is to organize efficient and effective markets, remedy market failures, and develop human resources. In transition economies such as the PRC, the State also has an obligation to mitigate the hardships caused by the transition. Reinventing the State to fulfill these roles effectively is a major development challenge.

Economic growth also depends on society's efforts, and therefore requires the State to create an enabling environment for development that encourages the participation of nonstate organizations, including quasi-government, nongovernment, nonprofit, and community-based organizations; and the private sector. Economic growth depends on a partnership between the State and society.

The ADB defines governance as Sound Development Management. This is an approach to managing the State and State-society relationships that enables the State to carry out its roles effectively. The approach calls for (i) all organizations and individuals to be accountable; (ii) public participation; (iii) transparent policies, rules, regulations, and laws and processes for implementing them; and (iv) predictability and continuity of development policies, rules, regulations, and laws that govern the development process. Such a management approach helps secure the effective markets that are necessary for economic growth and also enables nonstate actors to contribute to the development process. The Government of the PRC subscribes to the principles of sound development management. Evidence of the country's commitment may be found in the 10<sup>th</sup> Five-Year Plan (2001–2005), the Constitution (1982, amended), and various organic laws.

Sound development management has substantial direct and indirect linkages to poverty reduction. Poverty reduction, a principal goal of the PRC and the principal goal of the Asian Development Bank (ADB), depends on effective markets and the environment for growth with significant redistribution of the beneficial effects. Effective markets in turn are determined by economic and noneconomic factors. The goal of this report is to assess key factors that impinge on markets and inhibit growth. It first examines the structure of the State and then discusses such key issues as public financial management, core government functions, the interface between the public and private sectors, and the development of civil society.

During the past 2 decades the PRC has given economic development top priority. Economic reforms have included welcoming foreign investment, implementing an export-led growth strategy, decollectivizing agriculture, decontrolling prices, and replacing central planning with a market economy. As a result of these policies, economic growth has been short of spectacular. However, economic reform has been accompanied by increasing unemployment and dislocation, and a growing migrant workforce that is generally not entitled to education, health, and welfare benefits. Economic development has also been accompanied by increasing income disparities between urban and rural areas and between the western region and the east coast. The Government has designed new policies to correct these problems, such as the "go west" campaign, and is now implementing these policies (herewith referred to as "west"). The

country also faces challenges with its accession to the World Trade Organization (WTO), which will require key components of the economy, such as agriculture and the state-owned enterprise (SOE) sector, to become globally competitive. Development management should enable economic growth, and focus particularly on facilitating markets and improving the interaction between the economy's key actors—Government, nonstate sector, workers, and the financial system. The task of this report is to identify and suggest solutions to any development management impediments to sustained economic and social growth.

The PRC's political institutions are well entrenched and functional. They permit citizens to participate in policy making through various channels such as public hearings, legislative hearings, and advisory committees. Nevertheless, the Government could strengthen the institutionalization of these channels by requiring officials to consult citizens during the process of making laws and drafting rules. The Government could also consider a law on government information transparency.

The Government has made significant progress in the reform of public financial management. During the last 3 years the Ministry of Finance has embarked on a wide-ranging set of reforms that include introducing new procedures for budget preparation and approval—using a new budget classification scheme—and improving monitoring and auditing. A new treasury management system is under preparation, and the Government has passed a Procurement Law, a decisive step in adopting transparent and indiscriminative practices. However, further strengthening of the revenue-generating mechanism, especially the tax collection system, is needed. The report recommends a review of the value-added tax to see whether it could become a tax on consumption rather than on production and a review of enterprise income tax preferences to see whether they can be reduced. To better use the budget as a management tool, extrabudgetary funds should be brought into the budget. Improving the capacity to forecast revenues and strengthening the oversight role of the National People's Congress are also recommended. Finally, the Government should consider further reforming the system of intergovernmental transfers to ensure that they reduce the problem of growing regional income disparities.

In practice, local budgetary autonomy is limited by many spending mandates from the central Government, local governments' lack of taxing powers, and their dependence on transfers from the central Government. Despite the elaborate system of intergovernmental transfers, the overall effect of the transfer system is disequalizing. The administrative division of labor between central and local governments often lacks clarity. Moreover, many local governments lack the capacity to manage the responsibilities delegated to them by the central Government. Resolving these problems and improving local governments' capacity to manage development would significantly strengthen public financial management.

The system of public administration underwent significant reform in the 1990s, but despite restructuring and downsizing the Government, the administrative system remains highly compartmentalized. Improved coordinating mechanisms could enhance efficiency and reduce policy inconsistencies; the Ministry of Finance could play a more active role in determining the overall size and cost of the public sector. Furthermore, the authorities have established a new civil service system that is based on open competition, but abuses of the competitive selection system are ongoing and should be eliminated, and the Government's vigorous attack on corruption should continue. The Government should rotate more highly qualified officials to the poorer western regions of the country to improve local administrative capacities. It should also raise civil service compensation to bring it in-line with the private sector, to improve motivation, and to reduce the temptation of corruption. In addition, it should institutionalize the system of

popular participation in policy making by requiring public hearings, opening legislative hearings, and soliciting opinions.

The importance of improving governance at the local level is becoming a key development challenge. Improving the capacity of local governments to provide public goods and services, collect revenue and distribute local resources, implement regulations, control land use rights, and enhance investment and productivity will be a major area of intervention in the medium term. Strengthening local governance will be a significant factor in enhancing rural economic development and improving the welfare of rural households.

Considerable progress has been made in reforming the PRC's legal and judicial systems. Reforms have included expanding the number of lawyers and judges, improving law drafting capacities, improving the system of consultation on draft laws and their amendments, strengthening the capacity of the National People's Congress to consider laws, adopting educational and training qualifications for judges, and taking steps to ensure judges' impartiality. The legal process is also undergoing change, including upgrading the efficiency and quality of trials, improving regulations on evidence, and creating a computerized database to manage the records of court proceedings. The Government still needs to address the shortage of lawyers, weaknesses in law drafting capacities, and weakly institutionalized consultation mechanisms. Laws are characterized by inconsistencies and law enforcement by arbitrariness, and citizen complaints are often handled ineffectively. The Government should also strengthen its rudimentary legal aid system by, in particular, addressing understaffing and underfunding problems that impair its capacity. It should deal with the problem of judicial localism perhaps by creating a system of centrally financed national courts in the localities. Pay and other incentives for judges should be substantially improved. Despite the substantial progress that has been achieved during the last decade, the rule of law is not the norm because the State does not act as any other actor before the law.

Recent reforms have witnessed the growth of the regulatory state to manage a market economy. Central and provincial governments have promulgated thousands of new rules and regulations and established many new regulatory agencies; however, problems of clarity, consistency, arbitrariness, and lack of transparency are apparent within the regulatory regime. In part this stems from the lack of a well-functioning system for resolving ambiguities and inconsistencies once they become apparent in practice, and in part because agencies often issue regulations to empower themselves rather than to provide reliable guidance to affected parties. Dependence on local governments and/or on the collection of fines for funding has affected regulatory agencies' capacity to carry out their duties. Although redress mechanisms exist, their scope is limited. Public hearings on regulations are increasingly common, although voluntary. Corruption and noncompliance sometimes undermine the implementation of regulations. Although the Government has addressed these issues, more work remains to be done.

Sound development management is characterized by the efficient and effective delivery of public services. Many local governments have adopted new and innovative public service delivery systems that have included contracting out, franchising, and privatization, but many public services are provided by monopolies that do not permit citizens to realize the benefits of competition. Thus, to improve efficiency, greater efforts to reduce monopoly and increase competition are required. Further, despite considerable restructuring, the Government still provides many services that could be more efficiently delivered by nongovernment organizations (NGOs). Moreover, many agencies still use regulatory power as an instrument to protect and promote departmental or local interests. Such systems create rent-seeking

opportunities for public officials who use their discretionary power to extract payments and other forms of “contributions” from clients. Finally, a lack of transparency hinders attempts to hold agencies accountable for the delivery of public services.

Sound development management requires accountability in the sense that officials are accountable for their behavior and responsible to the entities from which they derive their authority (People’s Congress or the Communist Party of China). Bureaucratic accountability systems are reasonably well developed and the Government has implemented an official responsibility system at all levels. Auditing and accounting standards have been adopted that conform to international practice, and the statistical system is increasingly reliable. Nevertheless, in some instances these standards are arbitrarily required and are only weakly implemented.

Economic development depends on the combined efforts of the Government, NGOs, and the private sector. The Government has recognized the important contributions of the private sector to sustainable economic growth, but in many respects the bias toward state-owned property and the public sector remains and the private sector continues to suffer from many problems. These include (i) laws protecting the private sector, including a law to guarantee equal treatment, are incomplete, outdated, or nonexistent; (ii) uncoordinated policies sometimes cause confusion among private entrepreneurs; (iii) private entrepreneurs are discriminated against in entry to the market and require stronger regulation of the market to ensure order, a condition that benefits all business; and (iv) financing is often not available to the private sector, which is concentrated mostly in small and medium enterprises (SMEs). SOEs receive the majority of the allocations available through the formal financial system, while SMEs receive a much lower share than warranted by their importance in the overall economy (OECD). Solutions to these problems must be found to further develop the economy. The Government should redouble its efforts to focus on its new role as a service provider to both public and private entrepreneurs.

Creating modern economic enterprises involves improving the structure of corporate governance. The Government has expended considerable effort to reform the country’s SOEs. These reforms have granted SOEs autonomy and sought to separate enterprises from the Government through changes to their ownership and management structures. However, many SOEs are not performing well. The PRC’s accession to the WTO and growing numbers of well-informed domestic shareholders will put pressure on the regulatory authorities to strengthen the roles of shareholders, boards of directors, and boards of supervisors. Moreover, remuneration packages for managers should be tied to enterprises’ performance, and transparency in the way enterprises are governed should be improved dramatically.

Sustainable social and economic development requires the Government to partner with civil society in producing goods and services to meet community needs. As the Government has shed many responsibilities, especially for social services, the authorities have encouraged a kind of NGO unique to the PRC to fill the gap. The 1990s witnessed an explosive growth of NGOs operating in such areas as population, environment, poverty reduction, education, health, rural development, resource conservation, social services for the elderly and the disabled, and related gender issues. Many of these NGOs have a close and cooperative relationship with the Government (indeed, the Government has actively encouraged establishing most of them). This relationship has varied considerably, with some organizations exercising considerable autonomy in practice. Nevertheless, the Government regulates their activities and discourages establishing nationwide NGOs. Their capacity to participate in the policy process should be strengthened and their activities regulated by a law on NGOs.

Access to information is intimately related to economic development. Without access to information entrepreneurs cannot make informed investment and marketing decisions, which leads to inefficiencies. Although unprecedented numbers of PRC citizens now have access to the media and the Internet, government control in these two areas continues to be tighter than in most market economies.

The PRC's accession to the WTO will put pressure on the Government to solve these problems. The breadth of its commitments to open its export markets and to liberalize access to its domestic economy will permit more than economic gains. The WTO will accelerate access to technology significantly advance the country's legal and judicial system, and fast-track market disciplines (OECD).

The report examines these synthesized governance issues in depth and concludes with a discussion of recommendations for the Government, the development community, and ADB.

### **Recommendations for International Funding Agencies**

Opportunities for funding/development assistance can be found in many areas:

- In the area of public financial management, multilateral agencies such as the World Bank and the International Monetary Fund have been intimately involved in providing assistance for improved public financial management for many years.
- International funding agencies should continue to be involved in reform of the taxation system, budget reform, assistance to develop more effective forecasting models, and assistance to study improvements to the system of intergovernmental transfers.
- Development partners may consider assistance to strengthen local governments' capacity to manage development. Strengthened local capacity is especially needed in the western regions. To this end broadly based training programs that improve the governance skills of local community leaders will be critical in strengthening development administration in the next decade.
- The scope for collaboration in the area of public administration may focus on helping the Government reduce and eliminate corruption. Assistance in drafting laws that require public hearings and model participation in policy making, and that lay down processes for the hearings is needed.
- International funding agencies may also consider support for drafting laws to break up monopolies and foster competition.
- In the legal and regulatory area assistance is needed to support the development of a more reliable citizens' complaint system and provide additional training for lawyers and judges.
- International funding agencies may help the Government in establishing more effective consultative mechanisms in drafting and reviewing regulations.

- International funding agencies could provide support to government agencies in drafting their own procedures for making and applying rules and consider assisting the expansion of legal aid systems in the western regions, as most legal aid centers are operating in coastal regions.
- To strengthen the regulatory system, continuing reform of the statistical system is necessary to ensure that investment, pricing, and marketing decisions are based on accurate information. International funding agencies may work with local offices of the National Bureau of Statistics to improve the collection and handling of statistical data.
- International development partners have experience with providing assistance to support alternative public service delivery systems, such as contracting out, public-private partnerships, and privatization. Small projects could be established, particularly in the west and central regions, to experiment with some of these systems, while at the same time strengthening local governments' capacity to manage the systems effectively.
- Development of the private economy is moving ahead, but is still restricted by the traditional preference for the public sector. Additional opportunities present themselves for carrying out joint projects with NGOs that are committed to the private sector, such as the All-China Federation of Chambers of Commerce. International funding agencies may also increase their involvement in developing credit guarantee systems and microfinancing for SMEs. This could be done through a commercially viable vehicle to demonstrate the opportunities to other potential lenders.
- International funding agencies have already provided some assistance in corporate governance, but there are many opportunities for action. Development partners may assist in designing incentive systems for implementing appropriate corporate governance structures. Additional support to regulators such as the China Securities Regulatory Commission in designing packages of incentives for implementing corporate governance best practice is also needed.
- Some organizations, such as the Ford Foundation, have specialized in providing assistance to strengthen civil society and the capacity of NGOs in providing services to the public, and to help the Government in implementing policy. Future assistance should focus on capacity building to help NGOs participate in policy making to improve the effectiveness of public policy. Development partners may also increase capacity to contribute to further development of the private sector.

### **Recommendations for ADB**

To determine ADB's program of action for the PRC, resources should be targeted to interventions where ADB governance work can contribute to poverty reduction, where there is strong government ownership and long-term commitment to the development agenda, and where ADB's comparative advantage and value-added can be clearly demonstrated. ADB should maximize the impact of its operations and look for opportunities to leverage the use of scarce resources through strategic alliances and partnerships with other international development partners and the effective use of trust funds and other complementary financing schemes.

The development management agenda in the PRC is large, and to be effective ADB should focus on a few areas identified by the Government and build on ADB's existing expertise and strengths. Working with the Government to identify the most appropriate areas for ADB assistance is essential. ADB has been particularly effective in areas such as reform of public finance, legal (especially economic laws) and regulatory reform, auditing and accounting reform, and private sector development.

Developing the west and facing the challenges of the WTO membership are high priorities for the Government and should be reflected in ADB's program of action. Conducting training for provincial and local-level officials to improve their capacities, particularly in areas that influence poverty reduction, through the ADB Institute is recommended. ADB may also address regional inequalities through activities that enhance fiscal transfers and more equitable resource distribution from the central to local levels.

Given the importance of public financial management and ADB's expertise, ADB should work with the Ministry of Finance in identifying appropriate areas where additional assistance will have a significant impact. These areas may focus on assistance in drafting economic laws, such as revising the 1995 Budget Law, or in strengthening the regulatory framework for a market economy. Such assistance could include helping the Government draft procedures for government agencies in making and applying rules.

The PRC has a mediation system for resolving disputes, which works well. However, as the PRC is further integrated with the world economy, especially through accession to the WTO, the importance of the formal court system will likely increase in significance, especially for resolving commercial disputes. As the courts become more important, further development of the legal aid system to permit all citizens, including the poor, access to the courts will be necessary. Given ADB's expertise in the legal and regulatory areas, it may consider assisting the further development of the legal aid system, especially in the west. Such a project would clearly benefit the poor.

ADB has successfully provided assistance for the development of the accounting and auditing system, which is critical for accountability. Further reform in this area is necessary to strengthen the capacity of the Chinese Institute of Certified Public Accountants and other professional organizations to regulate the profession and raise accounting and auditing standards. Continuing reform of the statistical system is also needed to ensure that investment, pricing, and marketing decisions are based on accurate information. ADB may consider complementing the work of other development partners in assisting the National Bureau of Statistics or local bureaus to improve the collection and handling of statistical data, which is critical for ensuring public accountability.

Development of the private economy is moving ahead, but is still restricted. ADB can assist by continuing to sponsor and publicize research on the impediments to the development of the private sector and, through its work on the reform of economic laws and regulations, helping ensure a more level playing field. ADB may also assist in providing credit guarantee systems and financing for SMEs. ADB should continue to support the development of civil society as an alternative vehicle for delivering social services and in support of its role in improving accountability. ADB should work with other development partners in developing a government-led framework for civil society and an NGO law.

In addition to these more traditional activities for ADB, two additional areas are critically important for development management in the PRC. First, developing sound corporate

governance practices is crucial for further economic development. ADB may support government departments in designing appropriate incentive systems for implementing sound corporate governance structures. ADB may also support such regulators as the China Securities Regulatory Commission in designing packages of incentives for implementing corporate governance best practice. Second, while the Government has waged a fierce struggle against corruption, more remains to be done. In particular, ADB could consider a project to create and maintain a more enabling environment for clean government. In both these areas there is much scope for working with other development partners. ADB should continue its efforts to encourage the PRC in becoming a signatory to the ADB-Organization for Economic Co-operation and Development Asia-Pacific Anti-Corruption Initiative, an ongoing program of 19 Asian countries working collaboratively on anticorruption activities within a collective Action Plan.

Sound development management is essential for economic and social development. Only with sound development management can the economy grow, and this is a precondition for achieving other critical goals, such as poverty reduction. The PRC has made genuine progress in improving accountability, participation, and the predictability and transparency of operations in many key areas, including public financial management, public administration, the legal and judicial system, public service delivery, public accountability, development of the private sector, corporate governance, and the development of emerging civil society. Removing the remaining largely noneconomic factors that hinder economic growth will improve the development management situation in the PRC.

## I. INTRODUCTION

The fundamental development management challenge facing the Government of the People's Republic of China (PRC) is to reform the state structure so that it is appropriate for a market economy, while at the same time maintaining both economic growth and social stability. Only through economic growth can the PRC substantially reduce poverty. The State and society will both play key roles in achieving this goal.

The role of the State is to organize efficient and effective markets, remedy market failures, and develop human resources, all of which are critical for sustained development. In transition economies such as the PRC, the State is obligated to mitigate the hardships caused by the transition (UNDP 2001a). Reinventing the State to fulfill these roles effectively is critically important.

Economic growth also depends on society's efforts, and therefore requires that the State create an enabling environment for development that encourages the participation of nonstate organizations, including quasi-government, nongovernment, nonprofit, and community-based organizations; and the private sector. Economic growth depends on a partnership between the State and society.

The Asian Development Bank (ADB) in its 1995 Policy entitled "Governance: Sound Development Management" defines governance as "the manner in which power is exercised in the management of a country's social and economic resources for development." This is a particular approach to managing the State and state-society relationships that enables the State to carry out its roles effectively. The approach calls for (i) all organizations and individuals to be accountable; (ii) public participation; (iii) transparent policies, rules, regulations, and laws and processes for implementing them; and (iv) predictability and continuity of development policies, rules, regulations, and laws that govern the development process. Such an approach helps secure the effective markets that are necessary for economic growth and also enables nonstate actors to contribute to the development process.

Poverty reduction, a principal goal of the PRC and the principal goal of ADB, depends on effective markets and the environment for growth with significant redistribution of the beneficial effects, which are characterized by a level playing field. Effective markets can channel investment to help the poor, and pro-poor growth and poverty interventions (ADB 2001b). These are necessary preconditions for long-term, sustainable poverty reduction.

Effective markets are determined by economic and noneconomic factors. The goal of this report is to assess key factors that impinge on markets and thereby inhibit growth. It first examines the structure of the Government and then discusses such key issues as public expenditure management; core government functions (public administration, the legal system, public service delivery, and accountability); the interface between the public and private sectors, especially the creation of an enabling environment for the development of the private sector and corporate governance issues; and the development of civil society, including enhancing the capacities of nongovernment organizations (NGOs) to assist with development and with access to information.

## **A. Twenty Years of Reform: The PRC's Transition Economy**

During the past 2 decades the PRC has made economic development a top priority. Beginning in 1978 the authorities opened the country for foreign investment ("the open door policy") and adopted a strategy of export-led growth. The institutions of the PRC's centrally planned economy have been gradually replaced by mechanisms that are more appropriate for a market economy. The Government de-collectivized agriculture, put in place a system of household contracting, and gave the state-owned enterprises (SOEs) more autonomy. The authorities also decontrolled prices and decentralized and liberalized the right to engage in foreign trade. In 1992 the Communist Party of China (CPC) formally adopted the policy of replacing central planning with a market economy. One of the strengths of the PRC's transition from a centrally planned to a market economy is the gradualist approach taken. Old systems of development management were not dismantled until new systems were developed and tested. While this process takes considerable time, it reduces the cost of mistakes by testing new approaches at the local level before adopting new development management systems on a national basis.

As a result of these and other policies, economic growth has been nothing short of spectacular. From 1986 to 1990 gross domestic product (GDP) grew by an average annual rate of 7.9%, rising to an average of more than 10% per year from 1991 to 1999 (National Bureau of Statistics 2000a, p. 23). GDP growth reached a high of 14.2% in 1992, and even though it has declined somewhat since then, it achieved a respectable 7.1% in 1998–1999 and was between 7% and 8% in 2000 and 2001.

From 1985 to 1999 average annual per capita incomes of urban and rural workers increased from 748 yuan(CNY) to CNY5,888 and from CNY547 to CNY2,987, respectively.<sup>1</sup> As incomes have risen, so has the structure of the economy changed. Primary production, which contributed 30% of GDP in 1980, now only accounts for 17.7%. Secondary production, including industry and commerce, has remained stable at about 48–49% of GDP. The tertiary sector, however, has increased substantially from 21% to 33% of GDP. These changes are reflected in employment patterns. From 1980 to 1999 the percentage of the workforce employed in the primary sector fell from nearly 70% to 50%, while the number employed in the tertiary sector increased from 13% to 27%. The ownership structure of the economy is also changing. In 1978 virtually all-industrial production was in state or collective hands, but by 1999 SOEs accounted for only 28% of the value of gross industrial output. By the late 1990s the domestic private sector accounted for at least 13% of GDP or, using a broader concept of the private sector, up to 50% of GDP (ADB 2001a, p. 70).

The success of the PRC's development strategy is reflected in the country's relative position in the United Nations Development Programme (UNDP)'s human development ranking (Table 1). The PRC's human development index value was 0.718 compared with 0.564 for South Asia and 0.467 for Sub-Saharan Africa in 2001.

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<sup>1</sup> In 2001 CNY1 = \$0.121.

**Table 1: Human Development Rankings  
Selected Asian Countries, 2001**

Country	Ranking
Japan	9
Republic of Korea	27
Malaysia	56
Thailand	66
Philippines	70
<b>People's Republic of China</b>	<b>87</b>
Viet Nam	101
Indonesia	102
India	115
Cambodia	121
Lao People's Democratic Republic	131

Note: Rankings range from 1 to 162, with 1 being the highest.

Source: UNDP (2001b).

The structural changes have been accompanied by increasing unemployment, dislocation, and a growing migrant workforce. Although unemployment is officially only 3.1% in the PRC's cities, analysts estimate the rate to be 7–8% of the urban workforce if laid-off workers are included. By 2000 the number of urban unemployed had reached an estimated 20 million people. Total layoffs were estimated at some 23–25 million people, increasing at a rate of 4–5 million per year (UNDP 2001a, p. 70). An average 12–13 million new workers will enter the labor market annually. There are also currently about 150 million surplus rural laborers, many of whom wish to move to cities for jobs and a better quality of life. This number swells and contracts at times when crops are not being planted or harvested. Even with increasing emphasis on improving opportunities in the central and western provinces, rural enterprises are unlikely to absorb more than a fraction of the rural workers who will need jobs outside the agriculture sector. This reinforces the fact that development of the rural economy is increasingly dependent on conditions and policies affecting the economy as a whole (OECD).

Economic growth has been accompanied by increasing income disparities. In 2001 the Gini coefficient (a measure of inequality where 0 represents perfect equality) stood at 0.43 for the PRC, up from 0.28 in 1982—a growing disparity mostly accounted for by the gap between urban and rural incomes (see South China Morning Post, Hong Kong, China, 8 October 2001; UNDP 2001b). Countries with a Gini coefficient of 0.50 or higher are mainly concentrated in Africa and Latin America and among the poorest in the world. The PRC ranked 24<sup>th</sup> out of 90 countries on the UNDP's human poverty index (where 1 was the least poverty-stricken), with an estimated 18.5% of the population, or about 250 million people, surviving on \$1 per day or less, the international standard poverty norm (UNDP 2001b, p. 149).<sup>2</sup> These figures indicate the scale of the problem. The poorest parts of the country were located in the landlocked central and western areas, including the 12 provinces of Chongqing, Gansu, Guangxi, Guizhou, Inner

<sup>2</sup> The official poverty line in the PRC using CNY650/day places about 30 million people, in poverty. As a result of rapid economic growth and the Government's anti-poverty program, absolute poverty in rural areas fell from 80 million in 1995 to 30 million by the end of 2000. The Central Government alone spent about CNY25 billion (\$2.9 billion) on its direct poverty reduction program in 2000, about 29 times more than in 1980.

Mongolia, Ningxia, Qinghai, Shaanxi, Sichuan, Tibet, Yunnan, and Xinjiang, which together accounted for more than 27% of the total population.

Meeting the PRC's next challenge, the impacts of its accession to the World Trade Organization (WTO), will further transform the economy. Many sectors will have to undergo significant adjustments as the country's economy is opened to cheaper imports. The Government must encourage the restructuring of these sectors either to lower costs or to focus on higher-value products. Agriculture is one sector that will be particularly affected by WTO membership, but many others will also be. For example, the financial and insurance systems must be strengthened to compete with foreign banks, insurance companies, brokerages, and other financial institutions, and the legal and regulatory systems must be made more transparent and less arbitrary.

Pressure for reform has come both from within the PRC and from outside. Political pressure grew in the wake of the Cultural Revolution (1966–1976), when economic development was neglected and the economy stagnated. To regain the initiative and rebuild relationships with the people, in 1978 the CPC refocused the country's priorities toward economic development. Administrative and legal reforms became necessary as the economy developed, particularly after 1992, when the CPC adopted a market economy as the appropriate system for the country. Domestically, people are expecting better lives and higher incomes. Policies must be put in place so that certain groups are not excluded from the benefits of economic growth and to ensure that the social costs of the transition from a centrally planned to a market economy remain within tolerable limits. External pressure followed the decision to invite foreign investment into the country and to adopt an export-led development strategy in the 1980s. Pressures for change were generated by the PRC's increasing integration into the global economy, and its accession to the WTO has put additional pressures on the economic, administrative, and legal systems.

During the past 2 decades the PRC has confronted these challenges head on and made substantial progress. The economy has grown steadily throughout the reform era, and the country has also tackled the problems of reforming the SOE system by granting enterprises more autonomy, restructuring them, and reforming their ownership systems. Accountability has been increased through a variety of mechanisms, including the "cadre" responsibility system, the use of internationally benchmarked auditing and accounting systems, and a fierce campaign against corruption. Public policy making is more transparent and participative through the use of public hearings and various channels. Reform of the legal system and the judiciary has increased predictability. The PRC's emerging civil society is now a more active, if junior, partner in the delivery of many public services.

Further reform is needed, however, to ensure that the country's development management system serves economic and social development. Just a few areas of the many that require attention include public financial management; public administration; and the legal, judicial, and regulatory systems.

## **B. The Concept of Sound Development Management**

ADB's experience in Asia and the Pacific indicates that sustainable development depends not only on the quality of decisions made in relation to development and reform, but also on how these decisions are taken and carried out. In 1995 ADB members reached consensus to apply this fundamental lesson more systematically to ADB's overall operations (ADB 1995). This policy stresses the importance of sound development management, the core

elements of which are accountability, participation, predictability, transparency, and efficiency and effectiveness. Sound development management is one of the three pillars of ADB's Poverty Reduction Strategy. Without sound development management, efforts at reducing poverty will be ineffective. Poverty reduction requires economic growth and effective markets, which in turn depend on a basic foundation of capable institutions and sound practices.

The Government of the PRC fully subscribes to the principles of sound development management. Evidence of the PRC's commitment is found in the 10<sup>th</sup> Five-Year Plan (2001–2005), formally approved by the National People's Congress (NPC) in March 2001, and in other documents. For example, the plan, the Constitution of the PRC (1982, amended), and various organic laws emphasize the importance of accountability. The plan explicitly endorses measures to encourage clean government and to eliminate corruption (Chapter XXIII). In the plan, the Government endorses steps to increase participation, for instance, by reducing the barriers to labor mobility by reforming the household registration system (Chapter XI); providing a level playing field for all enterprises regardless of their ownership structure (Chapter XVI); holding public hearings on policy proposals (Chapter XVI); and encouraging community management systems and a greater role for NGOs (Chapters XVIII and XIX). The plan explicitly calls for the further development of democratic elections, policy making, management and supervision, and improvements to village self-government, along with community democracy and democratic management systems in enterprises (Chapter XXII). Improving predictability is also on the Government's agenda. The plan calls for further reform of the legal system to promote the rule of law and increased efforts to reform the judiciary and judicial systems (Chapter XXIII). Holding public hearings, requiring that public works projects be tendered (Chapter XVI), and mandating that more information on foreign investment flow be made public (Chapter XVII) are all actions designed to increase transparency. Finally, the Government encourages improved service quality and will adopt different modes, both governmental and nongovernmental, to deliver public services (Chapter V). Monopolies will be replaced by systems that foster fair competition to improve efficiency in providing public goods and services.

This report focuses on factors that impede or facilitate economic development.<sup>3</sup> It seeks, in particular, to identify those factors that may hinder economic development to help the Government craft strategies by better managing them or by minimizing or eliminating their impact. It also seeks to identify possible areas of ADB assistance that can focus directly on improving the PRC's sound development management regime.

<sup>3</sup> The terms of reference for this study precluded an analysis of political factors that might impede or facilitate economic development.

## II. BACKGROUND AND OVERVIEW

The PRC's Constitution dates from 1982 and was drafted to replace a Cultural Revolution-era document that did not serve the needs of economic development particularly well. According to the 1982 Constitution, the PRC is a unitary state that centralizes all formal political power in the central Government. While the central Government may delegate power to local governments, the center may alter or rescind such delegation at its discretion. The PRC is divided into 31 provincial-level administrations, including 4 provincial-level cities (Beijing, Chongqing, Shanghai, and Tianjin).<sup>4</sup> The provinces are divided into 331 prefectures (or prefecture-level cities), 2,109 counties (or county-level cities), and 44,741 towns or townships (see Appendix 1). On average, each province consists of 68 counties and each county is made up of about 20 towns or townships, but this varies tremendously. For example, Hebei Province is divided into 138 counties or county-level cities, while Anhui Province, with virtually the same population, has only 64 counties. In 1999 there were more than 600 cities of numerous administrative ranks throughout the country.<sup>5</sup>

Of the provinces, five are officially designated as autonomous regions. Thirty prefectures or prefecture-level units and 117 counties located in several provinces are also officially designated as autonomous units of government. The autonomous regions tend to be located in border areas and to have relatively large populations of ethnic minorities.<sup>6</sup> Generally the autonomous regions tend to have less autonomy than other entities because of their dependence on central government transfers, an outcome of their low level of economic development relative to the rest of the country. In practice, the richer coastal provinces, such as Fujian, Guangdong, and Shanghai, have exercised higher degrees of autonomy.

The Constitution does not establish a system of separation of powers, but formally recognizes the leadership position of the CPC in all key aspects of sound development management. According to the Preamble, economic and social development is carried out "under the leadership of the Communist Party and the guidance of Marxism-Leninism and Mao Zedong thought." The Constitution lays down the functions of the legislature, executive, and judiciary, all of which are carried out under the leadership of the CPC.

### A. The Legislature

Legislative functions are handled by people's congresses. At the apex of the system is the NPC, a body of approximately 3,000 delegates elected for 5-year terms, which according to the Constitution is the highest organ of state power (Article 57).<sup>7</sup> The NPC meets in plenary session once a year. In between these sessions its Standing Committee, a body of approximately 160 people, handles legislative business. The ninth NPC, elected in 1998, consists of government and party officials (33.1%), soldiers (9.0%), intellectuals (21.1%), and workers and peasants (18.9%). About 70% of all delegates are CPC members. Of the total, ethnic minorities account for 15.4% and women for 21.8%. Provincial people's congresses elect delegates to the NPC from among CPC-approved nominees. Historically the distribution of delegates has favored the cities; thus, each urban delegate represents significantly fewer

<sup>4</sup> This number does not include Taipei, China; Hong Kong, China; or Macau, China.

<sup>5</sup> Sixteen cities were designated as being at the vice-provincial level in 1994.

<sup>6</sup> Ethnic minorities make up about 8% of the total population of the PRC.

<sup>7</sup> The Recent White Paper entitled "Progress on China's Human Rights Cause in 2000" notes that the system of people's congress is a fundamental political system in the PRC.

people than each rural delegate. In 2002, for example, each urban delegate represented about 220,000 people, while each rural delegate represented about 980,000 people. This situation reflects the political system's urban bias. Provincial people's congresses are indirectly elected by county people's congresses, which in turn are elected by town and township people's congresses.

Universal suffrage—all citizens in good standing 18 years of age and older may vote—is provided for elections of delegates to town and township people's congresses, the most basic level of government. Voters generally only elect people's congress delegates and do not directly elect town and township government officials. In recent years, however, local officials have experimented with the direct election of township officials in Guangdong and Sichuan.

The NPC's four major functions are clearly defined and include those one would expect to find in any national legislature. First, the NPC legislates. Second, the NPC receives and investigates reports, such as those prepared on the work of government, the budget, and the work of the courts and procuratorate, and considers development plans. Third, the NPC investigates and decides on motions put to it by its Standing Committee or any group of 30 delegates. Finally, the NPC elects the country's most senior officials in the executive, military, judiciary, and procuracy (for a complete list of the functions of the NPC see Article 62 of the Constitution; see also Pu 1999, pp. 107–12). The NPC has the authority to remove the nation's most senior leaders from office.

The NPC's Standing Committee meets monthly when the NPC is not in session and exercises all the powers of the NPC. In addition, the Standing Committee is charged with interpreting laws; supervising the work of the State Council, the Central Military Commission, the Supreme People's Court, and the Supreme People's Procuratorate; and annulling administrative rules and regulations, decisions, or orders made by the State Council or local governments that contravene the Constitution or the law. In practice, much of the accountability to the people is exercised through the Standing Committee. According to the Constitution, no member of the Standing Committee may concurrently hold office in the executive, judiciary, or procuratorate. The chair is a member of the Politburo Standing Committee of the CPC.

To help it supervise the work of government the NPC has established numerous standing committees, including a committee for each of the following areas: nationalities affairs; law; finance and economics; education, science, culture, and publications; foreign affairs; overseas affairs; internal and judicial affairs (since 1988); environmental and resource conservation (since 1993); and agriculture and rural affairs (since 1998). Each committee has from 15 to 34 members. The establishment of new committees in the late 1980s and 1990s demonstrates that the structure of the standing committee system is kept under continuous review. The principal function of the standing committees is to examine draft laws or amendments to laws that come before the NPC.

The NPC has powers of financial and bureaucratic oversight that it exercises through its consideration of the annual work reports of the premier, the minister of finance, the auditor general, and the heads of the judiciary and the procuratorate. However, the NPC lacks a standing committee on the budget (though it does have a budget working committee). Such a standing committee would allow delegates to play a much more active role in supervising public finance. A proposed Supervision Law, which aims to define the power of members of the People's Congress at both national and provincial levels in supervising the Government and judicial systems, is under review.

People's congresses are established at the provincial, county, and town and township levels. They elect local leaders, such as provincial governors, county heads, mayors, and other local leaders and hear and approve reports on the government, public finance, audit activities, and the activities of the local judiciary and procuratorate. The CPC plays a key role in organizing and operating these institutions.

## **B. The Executive**

The President is Head of State.<sup>8</sup> The President, Vice President, the Chairman of the Central Military Commission, and the President of the Supreme People's Court are elected by the NPC. The President serves for a 5-year term and no more than two consecutively. After the NPC or its Standing Committee adopts laws, the President signs them before they become effective. The President appoints or removes the Premier, Vice Premiers, State Councilors, and Ministers in charge of ministries and commissions, the Auditor-General and Secretary-General of the State Council.<sup>9</sup> At the central level executive power is centralized in the State Council. The premier, who is also a member of the party's Politburo Standing Committee, heads the State Council. Following the premier's nomination the NPC elects other senior officials of the State Council, namely, vice premiers, state councilors, ministers, the auditor general, and the secretary general of the State Council.

The State Council is the executive arm of government and broadly speaking exercises five different kinds of authority. First, it exercises administrative rule-making powers to ensure that laws are implemented according to government intent. Second, it exercises the power to make proposals to the NPC and its Standing Committee, such as the proposals it presented to the NPC in 1998 to restructure and downsize central and local governments, or proposals for new laws or amendments to existing laws. About 80% of such proposals to the NPC come from the State Council. Third, the State Council exercises administrative leadership over all government agencies at the central and local levels. Fourth, the State Council exercises powers to supervise the implementation of approved policy by central and local government agencies. Finally, the State Council handles personnel appointments and the training, appraisal, and reward and punishment of government officials (see Pu 1999, pp. 350–51).

Since 1949 the State Council has undergone seven rounds of restructuring and downsizing. In 1998 the Government cut the number of ministries and commissions from 40 to 29 and the number of State Council officials from about 32,000 to 16,000. The trimmed State Council consists of 4 ministry-level agencies in charge of macroeconomic coordination, namely, the State Development and Planning Commission, the State Economics and Trade Commission, the Ministry of Finance (MOF), and the People's Bank of China; 8 specialist economic management ministries, such as the Ministry of Foreign Trade and Economic Cooperation and the Ministry of Agriculture; 5 ministries responsible for education, science and technology, culture, social security, and natural resource management; and 12 ministries in charge of state political affairs, including the ministries of Justice, Culture, and Foreign Affairs.

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<sup>8</sup> In 2001 the President of the PRC was concurrently also the General Secretary of the Central Committee of Communist Party of China (CPC); Chairman of CPC Central Military Commission; and Chairman of PRC Central Military Commission.

<sup>9</sup> Treaties and agreements concluded with foreign states by the State Council or its organs are promulgated by the President, upon decision of the NPC or its Standing Committee on whether to approve or annul them. He proclaims martial law; proclaims a state of war; and issues mobilization orders.

Provincial and local governments were restructured and downsized in 2000 and 2001. Generally they set up agencies at their level that correspond with those set up within the State Council. During the latest round of restructuring, the central Government required local governments to cut the number of employees by up to 50%.

To assist it in its work and to enhance coordination among agencies, the State Council has set up committees and leading groups that bring together representatives of relevant ministries and commissions to focus on a particular problem. Examples include the National Forestation Committee, the National General Headquarters for Flood Prevention and Drought Control, the Three Gorges Project Construction Committee, the State Council Leading Group on Poverty Alleviation and Development, and the Western Region Development Leading Group. The number of such groups and their functions vary from year to year. They are set up at the administrative level, are headed by senior officials, and are supported by general offices usually drawn from the State Council ministries that are most directly involved. For example, the Premier, whose portfolio includes agriculture, finance, and the environment, heads the Leading Group on Poverty Alleviation and Development; while the current Premier heads the Western Region Development Leading Group.

### **C. The Judiciary**

The judiciary consists of courts established at four different levels: basic level (town or township), intermediate level (county or equivalent), high level (province or equivalent), and supreme. The system is centralized in the sense that there is a single hierarchy of courts. It does not resemble systems in countries such as the United States and Canada, which have separate federal and state court systems. The judicial system is decentralized in the sense that even though judgments and court rulings at any given level are subject to being confirmed or overturned by courts at higher levels, the finances and personnel of courts at any given level are under the control of government at the same level. Moreover, there is little movement of personnel from one level of court to another, and promotion occurs primarily within a court. Officially sanctioned, informal village courts do not exist; however, in some places mediation committees may take on the functions of an informal village court in that they arrive at a view of the rights and wrongs of a dispute and attempt to remedy the situation through social pressure.

The court system is administered both vertically from the Supreme People's Court, whose role extends far beyond simply hearing cases on appeal, and horizontally from local-level government. The Supreme People's Court has a major role in collecting information about cases heard by lower courts, and periodically issues documents relating to court procedures and substantive law. While it is not the only body with authority over prescribed qualifications for judges, its agreement is necessary.

With a few minor exceptions, the president and vice presidents of a court are appointed by the People's Congress or its standing committee at the same administrative level as the court. These appointments are decided upon by the local CPC committee and its political-legal committee, and approved by the People's Congress. Local governments also control the courts' finances. Only the Supreme People's Court receives its financing from the central Government. As a result, courts tend to be dependent on local governments, and thus to be more responsive to local than to central concerns.

The State Council's Ministry of Justice has not traditionally played an important role in court administration. Recently, however, the Government has decided to require new judges and procurators (roughly equivalent to state prosecutors) to take the same examination that

lawyers must take. As the lawyers' examination is under the jurisdiction of the Ministry of Justice, this requirement will give the Ministry of Justice greater influence over the court system.

#### **D. The Public Sector**

In 1999 public sector employees numbered about 125 million (World Bank 2002), of which approximately 88 million were employed in SOEs and 37 million were employed either directly or indirectly in government. Civilian public sector employees accounted for about 33.4 million of the total. At both the central and subnational government levels, civilian public sector employees include those who work directly for government, that is, for core ministries and agencies that report to ministries; those who work for service units or institutions, such as hospitals, schools, and research institutes; and those who work for NGOs. Of the 33.4 million civilian public sector employees about 5.4 million white-collar administrators, managers, and professionals who work for "core government" are formally classified as civil servants and are employed primarily in local governments, while the remainder work for service units or institutions. Most are employed at subnational levels.

The civil service is managed not according to a civil service law (though there are plans to draft such a law), but according to the Provisional Regulations on Civil Servants, promulgated by the Ministry of Personnel in 1993. From 1993 to 1997 these regulations were gradually extended to include the bureaucracy of the CPC and its network of united front organizations, including the Youth League, the All-China Women's Federation, and the All-China Federation of Trade Unions, and to the people's congress system, the political consultative conference system, and then more widely to many "mass organizations." The regulations call for open, competitive recruitment of civil servants and selection based on examinations. Civil servants are to be promoted based on their ability and political integrity and rewarded according to their performance. The Provisional Regulations on Civil Servants call for the State to compensate civil servants broadly in-line with the remuneration received by managers of SOEs with the same level of responsibility.

The CPC's Organization Department, established by the CPC Central Committee, makes policy on the management of the civil service and directly manages the careers of the most senior officials. The State Council's Ministry of Personnel implements civil service management policy. Most civil service regulations are issued in the name of the Ministry of Personnel or of local personnel bureaus.

The Organization Department also makes policy on the appointment of the most senior officials of the 1,000 or so largest SOEs. In recent years it has delegated authority to approve these appointments to the high-level Central Large Enterprises Work Committee headed by one of the four Vice Premiers.

#### **E. The Policy Making Process**

The policy making process is coherent, and relevant stakeholders accept and understand it. Overall the process needs to be more transparent, but recently it has afforded the public more opportunities to participate than in the past. While there are coordinating mechanisms, the Government has no effective horizontal (coordinating) linkages. Rather, the system has strong vertical bureaucratic systems and weak horizontal sharing of information and coordination.

At the apex of the policy making system is the 23-member Politburo (21 full members and 2 alternates), 7 members of which constitute the Standing Committee, chaired by the party general secretary. The Politburo is elected for a 5-year term by the party's Central Committee, which in 2001 numbered 190 members and 149 alternates. The Central Committee is elected by the National Party Congress, a body of nearly 3,000 delegates who are indirectly elected by provincial party congresses. The PRC's approximately 65 million party members vote for delegates to town and township party congresses, which in turn elect county party congresses. These elect provincial party congresses in a system that resembles the people's congress system of elections. Party committees and party secretaries play a key role in nominating candidates for these elections. The relationship between the Politburo and the Central Committee is one of reciprocal accountability. Even though the Central Committee selects the Politburo, it does so based on the nominations of the Politburo itself. The Politburo also nominates Central Committee members and National Party Congress delegates. However, Politburo members also depend on support from Central Committee members. Thus the Central Committee exercises real power.

The Central Committee has a vast bureaucracy that plays a critical role in policy making. The most important actors are a network of joint party-state policy leading groups and committees. These commissions and groups are chaired by senior party officials, often Politburo Standing Committee members who also have government positions. The groups and commissions have their own staff and bring together officials from both party and government agencies to study policy options and make key policy decisions. The following list [Source: Radio Press, Inc. (2001, pp. 18–21)]. are the key economic and legal policy making commissions and groups as of 2002, namely:

- Central Finance and Economics Leading Group
- Central Finance Work Commission
- Central Large-Scale Enterprise Work Commission
- Central Rural Work Leading Group
- Central Political-Legal Commission
- Central Commission for Discipline Inspection

Policy options are fed into the groups and commissions from many sources, including research institutes and think tanks established by the various ministries and commissions of the State Council—the State Council's Development Research Center, the party's Central Policy Research Center and Central Party School, and the State Council's Chinese Academy of Science and Chinese Academy of Social Science. Several think tanks have been particularly influential, including the China Development Institute in Guangzhou, the Energy Research Institute of the Chinese Academy of Science, the Institute of World Economics and Politics of the Chinese Academy of Social Science, and the Shanghai Institute for International Studies. Although the number of think tanks is difficult to determine, observers estimate that the number of think tanks working in the area of environmental degradation alone has grown to more than 300 (Oxford Analytica 2002). The number and influence of think tanks grew rapidly in the late 1990s. Senior officials also have their own offices and advisors that carry out policy research. Many well-connected NGOs, such as the China Enterprise Confederation, carry out their own research on economic policy and feed recommendations into the system through their advisors, many of whom are senior party and government officials. Other organizations send recommendations to NPC delegates or to delegates of the advisory Chinese People's Political Consultative Conference.

Consensus in decision making is highly valued (Shirk 1993). This means that if a ministry or group is opposed to a particular policy, it can effectively amend, veto, or delay it. For

example, putting in place a retirement system for senior officials was delayed for several years in the 1980s until all concerned agreed on an appropriate system. The policy to build the Three Gorges Dam also illustrates the delays that can occur when consensus is not achieved. Although the most powerful leaders in the country endorsed the project in the 1950s, because of conflicting bureaucratic and regional interests, consensus to begin work was only achieved in the late 1980s. The development of elaborate systems of consultation that include all key government stakeholders is not surprising in a system that values consensus so highly.

The PRC's internal consultation system includes not only the commissions and leading groups identified earlier, but also networks of commissions and groups established within the State Council and at all levels of government. The consultative system also has a critical central–local dimension. Local, especially provincial, governments are consulted on all policy proposals that might affect them. Moreover, the Government convenes annual work conferences in areas such as economics and finance to air proposals and examine alternatives. Officials and experts in the relevant areas are invited to these conferences. Because of the strength of the vertical bureaucratic systems, however, issues tend to be referred to senior leaders for resolution.

The Government's agenda is set through the national economic and social development planning process, in 5-year cycles. In March 2001 the NPC approved the 10<sup>th</sup> Five-Year Plan (2001–2005). The plan lays out guiding principles and objectives. These principles take development as the main theme and restructuring as the main course of action. The principles call for further reform, especially coordinated economic and social development to improve people's livelihoods. The plan identifies sustainable development as the key strategic direction, and also lays down specific objectives: for example, by 2005 GDP per capita would have reached CNY9,400; 40 million urban and 40 million rural new jobs would have been created; urban unemployment would not have exceeded 5%; and the budget for research and development would have been more than 1.5% of GDP. The plan then identifies concrete measures for achieving these objectives, with special sections devoted to the economic structure, science and technology, and education and manpower; the population, resources, and the environment; the further opening and liberalization of the economy; the livelihoods of people; the country's spiritual life; the democratic legal system; and the strengthening of national defense. Two concluding chapters discuss the plan's implementation and emphasize the need to strengthen macroeconomic regulation and control to ensure social stability. The State Development and Planning Commission (SDPC), with the participation of relevant State Council agencies and local governments, prepares longer-term plans for the economy, the population, and other national policy issues.

Lack of consultation is evident in some public policy arenas, however, such as in key areas of public finance. Interviews with leaders of poor counties in Hebei, for example, indicate that they were not consulted in advance on decisions to raise civil service salaries or to undertake some capital construction projects for which they were expected to share in the costs. Even though the central and provincial governments provided supplementary funding, the supplements were generally insufficient, and local governments were expected to find the resources to cover the shortfall (World Bank 2002).

In recent years, public participation in policy making has increased and has taken several forms.

## 1. Public Hearings

Under new laws the Government is required to hold public hearings in some circumstances. For example, the Supreme People's Court in Beijing recently issued guidelines that would require government agencies to release information to litigants against agencies.<sup>10</sup> Attending a hearing is one-way citizens can influence government policy making, and the practice is increasingly recognized and used. There are two main forms of hearings in relation to government policy making. The first is a decision-making hearing, which the Government holds when decisions will influence citizens' interests, and where citizens may ensure that decisions are "reasonable." In July 2001 the Government enacted the Temporary Regulations on Government Pricing Decision Hearings, which came into effect on 1 August.

Under these regulations the Government must hold hearings to solicit the opinions of customers, operators, various levels of government, and related organizations when determining and revising the prices of public utilities, welfare services, and commodities produced by state monopolies that affect the interests of citizens, such as water, power, fuel, telecommunications, and railway transportation. The basic principle is to respect citizens' rights of "knowledge of and participation in public decision making." The law clarifies that in the absence of public hearings "price-regulating departments of the same level of government—as the agency determining the price—or a higher level of government should announce that the pricing violates price-making procedures and thus is null and void."

A second form of hearing is the legislative hearing. Traditionally the formulation of laws, regulations, and rules has followed the pattern of drafting by a regulatory body, then sending the regulation on to the NPC to consider and eventually approve. Such a process lacks citizen participation, and thus pays inadequate attention to the opinions of those whose interests may be directly affected by the proposed legislation. This situation has begun to change in recent years. While there are no established rules on legislative hearings, precedents have emerged in practice. For example, the provinces of Anhui and Guangdong and the cities of Shenzhen, Shenyang, and Shijiazhuang have all held public hearings on draft legislation. Insufficient information is available at this stage to indicate the level of impact that public opinion has on draft legislation.

## 2. Soliciting Opinions

Sometimes the Government solicits opinions from the public in the process of making decisions or drafting laws (Box 1). For example, when amending the Marriage Law in 2000 the Government collected citizens' opinions nationwide through the media and special meetings. Furthermore, when Beijing drafted its 10<sup>th</sup> Five-Year Plan, the municipal government held news conferences to gather opinions and posted a draft version of the plan on the Beijing economic information Web site to directly solicit ideas from the public. The Beijing Municipal Development and Planning Commission revised the plan to accommodate citizens' opinions. Similarly, the SDPC collected more than 10,000 responses from the public on the national 10<sup>th</sup> Five-Year Plan, which also was posted on the Internet, and accepted more than 300 of them.

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<sup>10</sup> The new guidelines, issued on 18 August 2002, permit the plaintiffs to ask the court's assistance in accessing information and bring about a more level playing field between private citizens and government agencies. The guidelines were generated due to increasing number of lawsuits against government agencies. Official statistics suggest that about 98,000 cases were recorded in 1998, a tenfold increase over the decade.

**Box 1: Public Opinion Invited in Qingdao**

In 2001 in the city of Qingdao in Shandong Province, the local government held public consultations to discuss development plans based on the city's regulation—Method for Public Participation in Urban Planning and Management. From 11 to 20 March, the municipal Planning Bureau and the Planning Design Review and Evaluation Center jointly invited comments on a private sector development plan for a particular site in the city. A special office was designated to receive comments on the plan during this period.

Source: Qingdao Daily (10 March 2001).

NGOs have also attempted to influence public policy. For example, the China Enterprise Confederation and the China Enterprise Directors Association—self-funded organizations that—mainly represent SOE managers—recommended in a written report to the Government in 2001 that the economic management environment for SOEs be improved; that the authorities strengthen control over the practice of arbitrarily collecting fees, levying fines, and demanding contributions; that the tax burden on enterprises be reduced; that corruption continue to be attacked; and that the rules and regulations for establishing competitive market conditions be improved (China Enterprise Confederation 2001, pp. 20–22). The Confederation's annual report, based on a survey of its members, was submitted to the nation's top leaders through various channels.

### **3. Advisory Committees**

Many government agencies have set up advisory committees staffed by experts and specialists to better inform themselves of the opinions of outside experts on public policy. Some government organizations have also set up consulting bodies and specialist consulting groups, both formal and informal.

### **4. Community Organizations and Community Participation**

With the development of rural grassroots participation and urban communities since the 1980s, citizen participation in community organizations and community affairs—mainly in the form of direct elections, villagers' self-governance, and community self-governance—has been an important development in public administration. According to the rules governing the consultation of villagers, significant issues—such as economic and social development, the establishment of welfare facilities, and the handling of problems of “major concern”—must all be decided on and executed through discussions of villagers' committees based on the relevant laws and regulations. Thus citizens who have sufficient knowledge and experience in community self-government can become alternative channels for exerting influence over public decision making.

### **5. Letters and Visits**

To learn about people's problems and to resolve these, the CPC and government agencies at all administrative levels have set up so-called letters and visits departments. This channel has become an important route for citizens to inform the Government about their views and to submit advice, criticism, and suggestions in relation to public decision making. This has helped the Government gain a better understanding of public complaints and of wrongdoings by

some government employees.

## 6. Constraints

Constraints hamper the effective use of these channels of participation. First, because educational levels are still relatively low, especially in the countryside, people are not equipped to engage the State in public debate over many public policies.

Second, public participation in policy making requires the transparency of government operations. Some progress has been made in this area, especially at the town and township level (Box 2). Indeed, governments in some provinces such as Jilin have pushed the openness of government operations to the county, municipal, and even the provincial level. However, the PRC does not have a government information transparency law. Moreover, transparency in government operations is still to some degree an exception and is not customary. Government information is still centrally collected and distributed. Transparency in relation to government information tends to concern the promulgation of administrative rules and regulations rather than details of government operations.

### Box 2: Matters to Be Made Public

According to the December 2000 CPC Central Committee and State Council General Office Circular on Implementing the System of Opening Government Affairs to the Public by Organs of State Power in Towns and Townships Nationwide, the following matters are to be made public:

- annual work targets of government departments and their implementation;
- government budgets and their implementation;
- amount and disposition of special funds allocated to the Government;
- claims made against the Government and its liabilities;
- government enterprise contracts, leases, and auctions;
- bidding and award of tenders for government engineering projects;
- government development projects;
- amounts and types of all taxes and fees collected;
- family planning situation;
- land resumption (the state taking privately held land to use for public purposes) particulars and resettlement arrangements;
- policies and practices for approving house construction;
- policies and practices for providing disaster relief and welfare;
- situation of collection of water and electricity bills;
- nature of the duties of government officials, their remuneration, and any disciplinary measures taken against them;
- situation surrounding any penalties to be levied in towns or townships, including the amount of the penalty and how and when it will be collected;
- matters related to officials' behavior;
- matters related to officials' use of entertainment allowances and traveling expenses;
- matters related to the transfer, appraisal, reward, and punishment of local officials; and
- other important matters.

Source: New China News Agency (Xinhua) (25 December 2000).

Third, the PRC generally lacks legal, institutionalized, thorough, and smooth channels

for civil participation. The existing routes also suffer from many restrictions. For example, legislative hearings are not required by law and are confined only to a few areas like pricing. While no institutionalized routes are available, random ones abound. A specialized public consulting system has yet to be established.

Finally, the administrative culture puts a premium on order, control, obedience, centralization, consistency, and confidentiality.

Increased transparency would foster a more trusting, cooperative, and sharing culture between the Government and its citizens. Citizen participation could then assist Government, and those who make suggestions and submit complaints would not be branded as troublemakers. Increased transparency would also reduce the patriarchal mind-set of some government employees and help change the country's administrative culture.

### **III. DISCUSSION OF SELECTED DEVELOPMENT MANAGEMENT ISSUES**

The following sections examine in detail critical development management issues in public financial management; public administration reform; the legal, judicial, and regulatory systems; public service delivery and performance; public accountability, the interface between the public and private sectors; and the role of civil society.

#### **A. Public Financial Management**

A well-functioning public financial management system requires three supporting components: (i) a healthy revenue mechanism that produces sufficient revenues to finance government in a neutral, nondistortionary, transparent manner; (ii) a budget management system that manages public resources efficiently, minimizing opportunities for graft and corruption while allocating resources in a way that reflects government priorities; and (iii) a bureaucracy that delivers services cost-effectively.

The current system in the PRC falls short on some dimensions of these three criteria:

- (i) The revenue mechanism is weak, generating only 15% of GDP, down from 35% in the late 1970s. At the same time, the Government raises large amounts of revenues off-budget, perhaps more than 20% of GDP, but in ways that are often inefficient, inequitable, nontransparent, and distortionary.
- (ii) The following weaknesses are apparent in the budget management system.
  - The budget is not comprehensive, and disparate agencies account for a large amount of off-budget spending, which is not subject to overall budgeting considerations.
  - Budget is prepared late in the fiscal year and spending units often do not receive authorizations until well into the fiscal year.
  - Budget adjustments are made throughout the year and are subject to negotiation.

- The central and subnational budgets are not well coordinated.
  - The system has few instruments for monitoring spending to ensure conformity with budget stipulations, leaving spending units with too much discretion.
  - Cash management is inefficient, causing waste and raising the cost of public spending.
  - The system does not ensure efficient delivery of services.
- (iii) The bureaucracy is poorly organized, poorly paid, and poorly motivated.

As the PRC enters its third decade of transition toward a market economy, the inefficiencies of its public financial management system are increasingly becoming a constraint. The Government has come to recognize that a fundamental reform of the system is required, and consequently, improving public expenditure management has become a top priority of the reform agenda. Over the last 3 years MOF has embarked on a wide-ranging set of reforms that include introducing new procedures for budget preparation and approval, using a new budget classification scheme, and improving monitoring and auditing. In addition, a new treasury management system is being prepared and the Government has passed a Procurement Law. Implementing these reforms will be prolonged and difficult. Given the PRC's five-tiered hierarchical system of fiscal management, the reforms will require that government agencies at all levels of administration implement major changes. For these reforms to succeed, commitment and support from the highest levels of political leadership will be needed.

## **1. Revenue Administration**

### **a. Revenue Trends**

Under the planned economy the PRC had a classic fiscal system of the Soviet type that drew overwhelmingly from the industrial sector for government revenues. The workings of this system depended on (i) fixed prices that favored industry, (ii) state ownership of industry and restricted entry, and (iii) compulsory procurement and mandated trade among producers at planned prices.

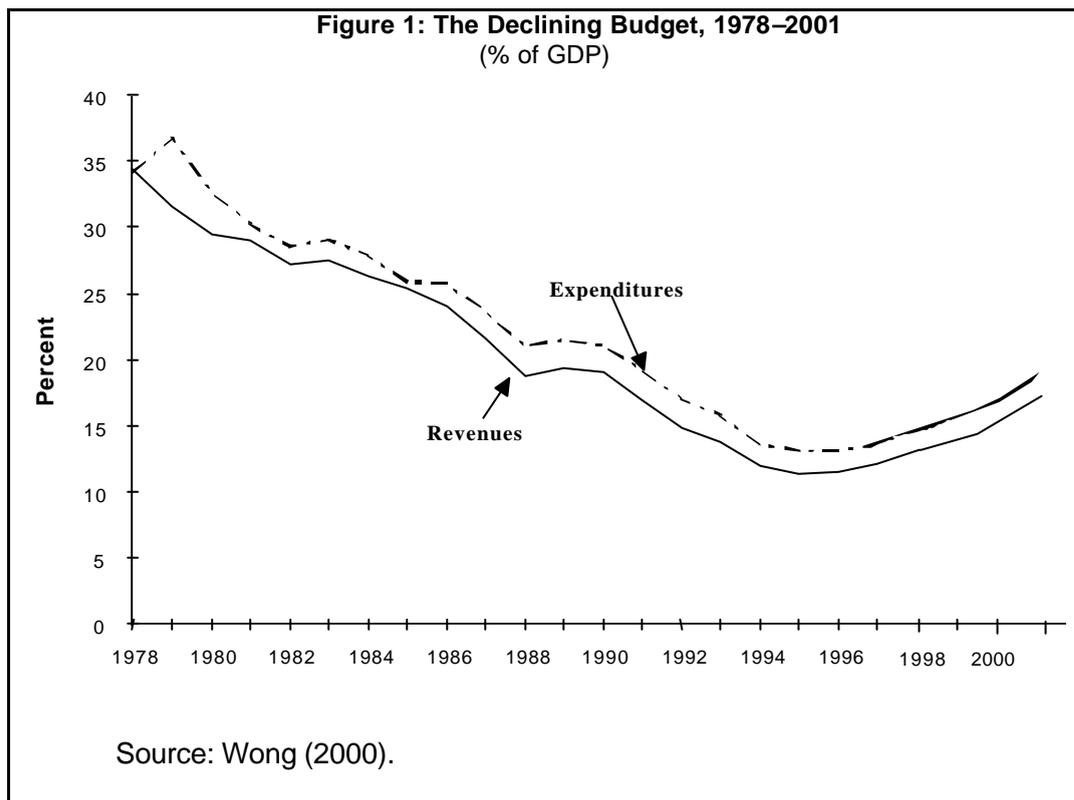
On the eve of reform in 1978, more than three quarters of government revenues came from the industrial sector and nearly half of total revenues came from remittances of profits from SOEs. Collection of revenue was easy, because SOEs' accounts were easy to monitor under the regime of fixed prices and planned production, and there were relatively few taxpayers—the largest few hundred SOEs accounted for the bulk of revenues. Even in the agriculture sector, which accounted for about 12% of revenues, the 50,000 or so people's communes were responsible for collecting the agricultural tax. As a result revenue management was easy, tax administration was simple and straightforward, and tax policy was unimportant.

The transition to a market economy brought about a collapse of the revenue mechanism, and government revenues fell from more than 35% of GDP in 1978 to a low of 10.7% in 1995. The primary cause was the dismantling of the planned economy and its control instruments, namely:

- The SOEs' profitability fell as prices adjusted to market forces, and the need to give SOEs incentives to generate profits meant less profit extraction.
- The emergence of private enterprises resulted in competition for profits.
- The Government's ability to collect taxes and monitor tax efforts was eroded across the board given the rapid changes in prices and market conditions.

Tax policy and tax administration lagged behind changes in the economy. The rapidly changing economic structure meant that the tax base was shifting. The traditional tax base of SOEs was eroding, and newly emergent sectors—such as trade, services, the export sector, and foreign-invested firms—were not well covered by the existing tax system. In addition, the shift to many taxpayers that resulted from such changes as disbanding the people's communes—which meant that the agricultural tax had to be collected from 200 million rural households—made the task far larger than collecting from the 50,000 communes.

These changes caused a prolonged, 17-year budget decline that was reversed only in the mid-1990s after the introduction in 1994 of the tax sharing system reform, which significantly rationalized the tax structure, strengthened tax administration, and revamped the revenue-sharing system (Figure 1). In 1996 the revenues-to-GDP ratio rose for the first time since 1978, and has continued rising through 2000. As a result the budget has recovered to about 15% of GDP.<sup>11</sup> Despite this progress the PRC's fiscal system is far from fixed.



<sup>11</sup> This is the consolidated budget for all levels of government.

## b. Tax Policy

A sound tax system with an appropriate mix of well-designed tax instruments is essential for mobilizing revenues to finance government operations. Through the 1980s and 1990s the Government introduced several new taxes to adapt to the new economic environment. In 1983 it introduced a corporate income tax on SOEs to replace profit remittances. In 1994 the Soviet era, product-specific turnover taxes were replaced by a value-added tax (VAT), a business tax, and an excise tax on luxury goods to improve the system's transparency and to eliminate cascading; and the income tax was unified for domestic enterprises. Overall, the improvements have been significant.

The current tax system comprises 23 types of taxes that are assigned either to the central or to local governments.<sup>12</sup> Only the VAT and the securities trading tax are shared in fixed proportions. The dependence on indirect taxes is high: nearly two thirds of tax revenues come from indirect taxes, with the VAT accounting for 40%. In contrast, direct taxes account for only a little more than 10%, agricultural taxes for less than 5%, and customs duties for 3% (until the 1999 and 2000 antismuggling campaigns increased collections).

Significant problems remain, however, in particular, revenue adequacy. At 15% of GDP the formal tax system is still not generating sufficient revenues to finance government at an adequate level. Moreover, the major types of taxes are still distortionary.

The VAT is an origin-based tax on production that excludes many services, which are subject to a business tax collected by local governments. The design of the VAT hampers export competitiveness, penalizes investment, and generates distortions through cascading. The Government is considering moving to a VAT on consumption to eliminate the discrimination against investment, but this reform is constrained by revenue considerations. To exempt investment from VAT would reduce VAT receipts by 30–40% without an offsetting rate increase, but at 17% the VAT rate is already high.

Receipts from direct taxes are low for several reasons. The enterprise income tax regime is rife with tax preferences introduced by the many successive coastal development and export promotion schemes, as the PRC does not have mechanisms for periodically reviewing tax expenditures to eliminate programs that are no longer needed. Foreign-funded enterprises enjoy liberal tax preferences that permit multiyear tax holidays on profits, an advantage not available to domestic enterprises. These features of the enterprise income tax add to the tax system's complexity and result in revenue losses and unfair competition among enterprises. The more favorable tax treatment of foreign enterprises also gives domestic enterprises an incentive to take money offshore and recycle it as foreign direct investment. The Government is considering unifying corporate tax rates for domestic and international companies to help level the playing field. The personal income tax has a narrow base and generates relatively little tax revenue except in municipalities like Beijing and Shanghai, where foreign businesses are concentrated.

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<sup>12</sup> Specifically, the tax system provides for three turnover taxes (VAT, consumption tax, and business tax), three income taxes (income tax on domestic enterprises, income tax on foreign-funded enterprises, and individual income tax), two resource taxes (resource tax and land use tax), two property taxes (residential property tax and urban real estate tax), four special purpose taxes (city maintenance and construction tax, farmland occupation tax, fixed asset investment tax, and land appreciation tax), six behavioral taxes (vehicle usage tax, vehicle license tax, stamp tax, deed tax, slaughter tax, and banquet tax), two agricultural taxes (agriculture tax and animal husbandry tax), and customs duties.

### **c. Tax Administration**

The State Administration of Taxation (SAT) plays the main role in administering the tax system. It is a government agency with ministerial-level status that reports directly to the State Council. SAT consists of the National Tax Service, which employs 668,000 staff and is responsible for collecting central government taxes and some of those taxes that are shared with local jurisdictions, and various local tax services, which employ 511,000 staff and are responsible for collecting local taxes and other shared taxes. SAT has direct line and budgetary control over the operations of the National Tax Service and provides functional guidance for, and supervision of, the local tax services, whose budgets and staff are provided by local governments. In most locations local financial departments collect the agriculture and agricultural husbandry taxes and the deed and farmland occupation taxes. The customs administration manages customs duties as well as the VAT and consumption taxes collected at the import stage.

Effective tax administration is essential to mobilize resources for government operations and to ensure that the intended objectives of tax policy are achieved. During the 1990s the Government implemented a series of tax administration reforms, including enacting the new Law on Tax Administration and Collection, standardizing many tax returns, dividing the tax administration into separate national and local tax services, and establishing more than 6,000 full-service tax offices. Despite these impressive achievements, however, tax collections remain significantly below their potential, and further improvements in such areas as computerization and judicial reform will be needed to strengthen tax collection and SAT's capacity to enforce tax laws. Improving tax compliance and collection is a key element in strengthening the fiscal position of all levels of government, including eliminating "unfair taxes," such as those that burden the poor, like agricultural taxes.

## **2. Public Expenditure Management**

The weaknesses of the budget management system are well recognized, and the Government has embarked on an ambitious set of reforms that aim to move the PRC closer to the Organization for Economic Co-operation and Development model for budgetary management.

### **a. Budget Formulation**

The greatest weakness of the budget formulation process is that it is not comprehensive. Under central planning, allocative decisions by the Government had been only partially reflected in the budget, while the central plan, administrative prices, and the credit plan all played important roles in directing resources to achieve government objectives. As budgetary revenues fell from 35% of GDP to less than 12% during the transition, all levels of government imposed a wide array of levies and surcharges to generate extrabudgetary revenues. Through much of the 1990s the Government continued to implement its industrial policy through directed lending, and financing social expenditures through SOEs.

Estimates of the size of extrabudgetary spending by the Government vary. The following are the estimates for 1999, compared with current year budget revenues of 14% of GDP:

- (i) fees and levies collected by branches of government: 12% of GDP;

- (ii) expenditures of branches Government that are not reported in budgetary or extrabudgetary accounts: 3–4% of GDP or more;
  - tax expenditures (tax incentives or tax credits): a conservative estimate is 1–1.5% of GDP;
  - payments arrears, including unpaid/deferred wages to teachers and civil servants, unpaid subsidies to the grain marketing system, unpaid interest subsidies to the banking system on policy loans, and unpaid utility and telephone bills of government agencies, account for approximately 1% of GDP;
  - quasi-fiscal expenditures of enterprises for surplus labor (hidden unemployment); for expenditures on workers' education, health care, and housing, estimated at 1% of GDP;
  - goods and services provided to the government at less than full compensation;
- (iii) quasi-fiscal government expenditures, that is, directed credit to SOEs: estimated to average 6–8% of GDP during 1985–1995, less in recent years—perhaps 3–5% of GDP; and
- (iv) commercial income or losses of government branches and revenues from asset sales: sizable during the early 1990s, but much smaller in recent years as the real estate bubble has burst: 1–2% of GDP.

In total, the extrabudgetary funds and the Government's extrabudgetary activities add another 19–24% of GDP to overall government spending. This far exceeds the official statistics for extrabudgetary funds, which account for only the first item in the foregoing list and part of the fourth item. Adding together the formal budget and the extrabudgetary activities produces a total size of government at 33–38% of GDP, substantially higher than expected at the PRC's per capita income level.<sup>13</sup>

The existence of these extrabudgetary resources should not be equated with corruption, but should rather be seen as a response to a system where expenditure responsibilities have been devolved to lower levels of government through a cascading process throughout the transition period without the assignment of commensurate revenue sources. Nonetheless, the implications are important, and in many ways are harmful to the budget process.

- The existence of these large resources outside the budget framework weakens the budget process in prioritizing spending, financial reporting, and internal controls.
- They represent a de facto decentralization of tax and spending authority that undermines the central authorities' ability to impose aggregate fiscal discipline, thereby reducing budgetary performance in the core functions of stabilization, equalization, and resource allocation.

<sup>13</sup> The expected size of government at the PRC's income level is closer to 25% of GDP based on international averages.

- They provide a soft budget constraint for all levels and units of government that has allowed the Government to stay bloated in terms of spending programs and staffing levels.
- They have contributed to worsening popular perceptions of the Government, as fees and levies are often viewed as abusive.
- They are less transparent than other sources of funds and are subject to less oversight. In other countries the absence of transparency and oversight is generally correlated with higher levels of corruption.

The budget formulation process is not comprehensive in another sense: the separation of capital and recurrent budgeting. While MOF manages the recurrent budget, the SDPC manages the capital budget.<sup>14</sup> This creates coordination problems, because MOF does not participate in considerations of the recurrent costs of supporting new projects, but is simply presented with their carrying costs once the projects are approved. Decisions on the number of civil service staff and their wage costs are also not made solely by MOF but together with the State Commission on Public Sector Reform and the Ministry of Personnel.

Current reforms are aimed at speeding up the budget formulation process to ensure that spending authorizations are made prior to the start of the fiscal year, as well as to reduce opportunities for budget adjustments during the year, which in the past have significantly eroded budget priorities. The reform to introduce organization budgets also requires reporting the sources and uses of extrabudgetary funds for each organization. This is an important step toward extending budget coverage to include off-budget resources and to improve allocative efficiency.

#### **b. Revenue Forecasts**

The art of revenue forecasts is underdeveloped in the PRC. Government bureaucracies have only just begun to carry out modeling exercises, while research organizations more skilled in modeling have not had access to the needed, but confidential, data.

Traditionally the SDPC makes forecasts for overall economic growth and capital investments. These are then turned over to MOF and SAT for their inputs. MOF is traditionally passive in terms of revenue forecasts, while SAT is more sophisticated in terms of modeling; however, neither is able to forecast revenues accurately—a challenging task even when sophisticated tools are available. For example, the robust revenue growth in recent years, especially in VAT revenues—which has grown much faster than GDP—has not been explained well. MOF does not receive growth targets promptly from the SDPC, which hinders its own forecasting. Research organizations such as the State Council Development Research Center, which has a large computerized general equilibrium model, and the Institute of Quantitative Economics, make alternative projections; however, both institutions concentrate on economic growth and trade modeling, and give low priority to revenue forecasts. In addition, neither institution has a strong core of fiscal economists.

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<sup>14</sup> The State Science and Technology Commission and an agency within the CPC also manage some parts of the capital budget.

In any case, the process has been based on extremely conservative forecasts of revenues and expenditures in the initial budget, which goes well beyond prudence in formulating the budget. This has undermined the priority-setting objective of the budget process by permitting too many adjustments during the fiscal year that dilute the link between the budget and policy priorities.

#### **c. Lack of Multiyear Expenditure Frameworks**

The budget process is an annual one and contains no reference to multiyear considerations; neither is it aligned with the Five-Year Plan.

#### **d. Role of the Legislature in Budget Approval**

The NPC is the PRC's parliament, the highest organ of state power. Officially the NPC approves the budget; however, as the NPC only meets in plenary session in March while the fiscal year begins in January, the budget is not enacted until well into the fiscal year. The Government presents its budget proposal to the NPC at the beginning of the plenary session in March; the NPC session has only two weeks to deliberate. The NPC can only approve or reject the budget in total and cannot amend it.

The NPC does have influence on the budget informally, and has exercised this increasingly in the last 2 or 3 years. It does so through the parliamentary budget process, which starts in January, about 6 to 8 weeks prior to the introduction of the budget proposal to the NPC in plenary session. During this period the NPC's Budget Commission and MOF hold discussions on the draft budget and the Commission can comment on it.

During the fiscal year, MOF provides quarterly reports on the implementation of the budget to the NPC's Economics and Finance Committee. Nonetheless, MOF has generally made adjustments to the budget during the course of the year without consultation with or approval by the NPC.

The authorities interpret some legislation passed by the NPC as conveying a "sense of the NPC" rather than being binding. Examples of this include the numerous laws and regulations calling for spending increases on selected sectors, for instance, for spending on education to grow faster than revenues. The organic Budget Law enacted in January 1995 had called for creating organizational budgets, but this was not done until the 2000 budget, after the NPC again called for them.

#### **e. Budget Execution**

At present the PRC has no effective treasury system, but this is one of the areas where the Government has ongoing reforms. The current system was adapted from the Soviet system in the 1950s. It records the transfer of funds from the central treasury account to ministry-level bank accounts in commercial banks. From there the money is transferred to the bank accounts of the spending units, from which actual spending takes place. Reconciliation with bank account statements only takes place with the final accounts, after the budget year has closed.

The treasury management system results in a large float of government money in the banking system. Currently there are over 13,000 government organizations at all levels of

administration. Once the budget is approved, these organizations receive money in bulk from the finance bureaus, and the monies are deposited in scattered accounts in commercial banks. At any given time MOF is financing idle balances, which are often significant. At the same time, as there is no general ledger, the appropriations are transferred through a cascading process that often involves several layers of organizations before reaching the end user. Delays are common.

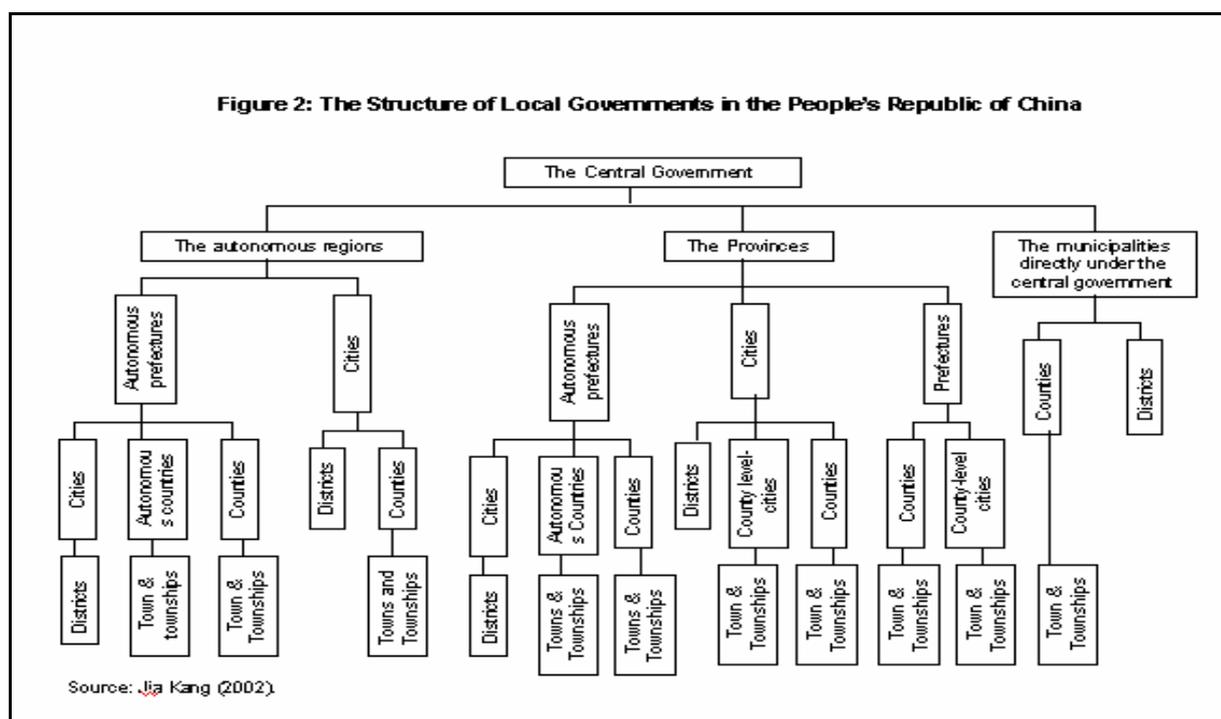
The PRC has an elaborate reporting system for the Treasury and for spending units. Spending units report monthly and annually to supervising ministries, which compile reports for MOF. MOF, however, only evaluates the annual reports. The system is ripe for abuse given the absence of effective checks on how the money is eventually spent. Reports on the use of funds are made long after the fact, and much information is lost through aggregation at each layer of reporting. The ongoing reform to establish a single treasury account at the People's Bank of China, managed by MOF, should be a big step toward improving expenditure alignment and control.

### **3. Decentralization and Intergovernmental Fiscal Relations**

The fiscal system has five levels, corresponding to the structure of government.<sup>15</sup> As described earlier, below the central Government are 31 provincial-level units, 331 prefecture-level units, 2,109 counties, and 44,741 townships (Appendix 1). By conventional measures of decentralization, such as the share of public expenditures at different levels, the system is highly decentralized. Subnational governments account for more than 70% of total budgetary expenditures, with more than 55% at the subprovincial levels. (Figure 2).

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<sup>15</sup> This section draws on Wong (1997) and World Bank (2000).



Constitutionally the PRC has a unitary system, but a strong federalist character derives from the arrangement of the administrative system as a nested hierarchy. The central Government determines the broad outline of the system, but only deals directly with the provinces. The central Government sets the revenue-sharing rules with the provinces, leaving the latter with substantial flexibility in setting the rules for subordinate levels. Each province specifies the sharing system with its prefectures, the prefectures specify the rules for their counties, and so on. Expenditure assignments are similarly structured. The Budget Law set the division of expenditure responsibilities between the center and the provinces, but the intermediate layers decide how local responsibilities are shared among the subprovincial levels.

Nominally the Budget Law, enacted in January 1995, confers substantial autonomy on each level of government: each level should have an independent budget that is approved by the people's congress at that level. The local people's congresses check whether the budget conforms to national laws and local regulations, after which budgets are submitted to MOF for the record and for the compilation of the state budget. While the budget speech of the minister of finance to the NPC still presents the consolidated budget, the NPC approves only the central budget. In practice, local budgetary autonomy is severely limited by the many spending mandates emanating from the central Government (most recently in the civil service wage increases that are only partially offset by earmarked transfers), the lack of taxing powers, and the high dependency on central transfers (Table 2).

**Table 2: Local Government Dependence on Central Transfers**  
(selected years, 1990–2000, as % of GDP)

Item	1990	1993	1996	1999	2000
Expenditure Share of Local Governments	67.4	71.7	50.5	68.8	65.3
Surplus or Deficit <sup>a</sup>	(1.2)	6.2	(22.4)	(19.8)	(17.5)
Share of Expenditure Financed by Transfers	2.0	0.0	44.0	40.0	37.0

<sup>a</sup> Difference between local revenues and expenditures.

Source: National Bureau of Statistics (various years).

Since 1994 revenue assignments have been structured according to the tax-sharing system, which is a combination of tax sharing on a derivation basis and own revenue assignment. Under the tax-sharing system all taxes are assigned to the central Government, local governments, or are shared (Table 3). The major shared tax is the VAT, which is 75% central and 25% local.

**Table 3: Tax Assignments, 1998**

Level	Tax	Central Share (%)
Central Taxes	Domestic Excise Tax	100
	Customs Duties	100
	VAT and Excise Tax on Imports	100
Local Taxes	City and Township Land Use Tax	0
	Farmland Occupation Tax	0
	Fixed Assets Investment Orientation Tax	0
	Land Appreciation Tax	0
	House Property Tax	0
	Urban Real Estate Tax	0
	Vehicle and Vessel Use Tax	0
	Vehicle and Vessel License Plate Tax	0
	Deed Tax	0
	Slaughter Tax	0
	Banquet Tax	0
	Agricultural and Animal Husbandry Taxes	0
Shared Taxes	Domestic VAT	75
	Personal Income Tax	50
	Business Tax if Paid by Railroads, Headquarters of Banks or Insurance Companies, and 3% Resource Tax	100
	Business Tax for Others	0
	Enterprise Income Tax if Paid by Headquarters of State-Owned Commercial Banks and Policy Banks, China National Petroleum Company, China Petrochemical Corporation, China National Offshore Oil Corporation, and China Post	100
	Enterprise Income Tax for Others	50
	Resource Tax if Paid by Offshore Oil Companies	100
	Resource Tax for Others	0
	City Maintenance and Construction Tax if Paid by Railroads or Headquarters of Banks or Insurance Companies	100
	City Maintenance and Construction Tax for Others	0
	Securities Tax if Collected on Stock Transactions	88
	Securities Tax Otherwise	0

Source: SAT.

In addition to their own revenues under the tax-sharing system, local governments receive five different types of transfers from the central Government:

- (i) **Tax rebates.** These provide each province with 30% of the increase in VAT and excise taxes over the 1993 base. This is the dominant component of transfer that has accounted for more than 70% of the total, though its share has declined in the past 3 years.
- (ii) **Quota subsidies.** This is a continuation of the pre-1994 subsidy for poor and minority provinces, whose amount increased from CNY8.6 billion in 1987 to CNY11.3 billion in 1998.
- (iv) **Earmarked grants.** There are hundreds of different earmarked grants, all of which are allocated on an ad hoc, negotiated basis for a variety of central government programs such as SOE subsidies, environmental protection grants and promotion of universal basic education in poor areas. In the past 3 years this category has increased rapidly, as MOF has routed much of the spending under the fiscal stimulus program through earmarked grants. In 1999 earmarked grants also included CNY7.6 billion to help localities pay pension arrears, and another CNY6.3 billion to help pay unemployment compensation for workers laid off from SOEs. The earmarked grants have also been used to offset the cost of central mandates, including CNY7.3 billion in 1999 to help localities defray the costs of a 30% increase in pension benefits decreed in July 1999 and nearly CNY30 billion for the civil service pay increase. In the 2001 draft budget, earmarked grants increased to CNY256 billion and accounted for half of central government transfers.
- (v) **Transition period transfers.** These were introduced in 1996 to provide resources for equalization across provinces. They are rule based and rely on variables such as provincial GDP, student-teacher ratios, number of civil servants, and population density. However, these transfers have been underfunded since their inception, accounting for just 2% of total transfers.
- (vi) **Final account transfers.** These are ex post transfers to compensate provinces for central government policy changes or unforeseen costs for which the central Government is responsible, such as the costs of bailing out local financial institutions.

Figure 3 shows that the overall effect of the transfer system is disequalizing. This is mainly because of the dominance of the origin-based tax rebates and the lack of a strong equalizing effect of the other transfers.



**Table 4: Fiscal and Economic Indicators—  
Rich and Poor Provinces, 1990 and 1998**

Indicator	1990	1998
Five Richest Provinces <sup>a</sup>		
Percentage of GDP	22.8	25.1
Percentage of Population	12.7	12.2
Percentage of Revenue Collections	26.0	23.0
Percentage of Government Expenditures	19.8	18.5
Five Poorest Provinces <sup>b</sup>		
Percentage of GDP	12.7	11.7
Percentage of Population	18.9	18.7
Percentage of Revenue Collections	12.3	9.8
Percentage of Government Expenditures	14.0	8.6

<sup>a</sup> Beijing, Guangdong, Shanghai, Tianjin, Zhejiang.

<sup>b</sup> Gansu, Guizhou, Henan, Jiangxi, Shaanxi (Hainan and Tibet are excluded because data were not available).

Source: Bahl (1999); National Bureau of Statistics (1991, 1999).

**Table 5: Health and Education Status of the Poor, 1988 and 1995**

Indicator	1988		1995	
	Nonpoor Regions <sup>a</sup>	Poor Regions <sup>b</sup>	Nonpoor Regions <sup>a</sup>	Poor Regions <sup>b</sup>
Individual Income (CNY)	206	222	543	552
Completed 5 years of Schooling (%)	68	54	53	42
Illiterate (%)	25	38	27	37
Household Medical Expenses (CNY)	14	11	125	124
Medical Expenses as a Percentage of Household Income	1.5	1.2	5.6	5.5

<sup>a</sup> Beijing, Guangdong, Shanghai, Tianjin, Zhejiang.

<sup>b</sup> Gansu, Guizhou, Henan, Jiangxi, Shaanxi (Hainan and Tibet are excluded—data were not available).

Source: Riskin, Renwei, and Shi (2001).

## B. Public Administration Reform

A sound system of public administration requires a competent bureaucracy that delivers services cost-effectively. First, the bureaucracy should be well organized and staffed with personnel at the appropriate levels who have been assigned clearly defined functions. Second, the personnel should be selected based on merit. Third, the staff should possess the expertise needed for effective leadership of the development process. Fourth, the staff should be highly motivated. Finally, the personnel should exercise their powers impartially and operate with integrity.

Although the PRC has made considerable progress in reforming the civil service system since 1993, the bureaucracy still falls short of meeting some of these criteria:

- Despite numerous campaigns to restructure the bureaucracy and make some progress, it is still overstaffed and has overlapping and unclear lines of responsibility.

- While there is now a system of open competitive examinations for hiring staff for most entry-level positions, abuses such as buying and selling posts still occur, especially at the local level.
- For many years, there has been a system of training that includes a variety of techniques, including job rotation, and the education levels of leading public officials have risen dramatically since 1980. Nevertheless, public administration is in the hands of underqualified officials, especially in some western provinces and regions.
- Government staff has received pay increases as a result of reforms of the compensation system, but their remuneration still lags substantially behind compensation levels in the private sector. This has contributed to low morale and the loss of some well-qualified staff.
- Even though the Government strongly encourages civil servants to exercise their power impartially and has waged a fierce battle against corruption, instances of local protectionism and corruption continue to undermine the integrity of the public service.

### **1. Government Restructuring**

Since 1949 the Government has undertaken seven major campaigns to restructure itself (Liu 1998). Until the campaigns of the 1990s (1993–1996 and 1998–2001) these exercises had been aimed mainly at streamlining the bureaucracy and usually involved abolishing ministries and agencies or merging them, making minor changes to their functions, and attempting to clarify lines of responsibility. As downsizing efforts they largely failed: short-term cuts were soon followed by renewed expansion. As the economy developed and technology changed, the PRC's central planning apparatus grew to accommodate new challenges.

In 1992, when the Government decided to replace central planning with a market economy, restructuring took on new urgency and new content. The 1993–1996 campaign was the first to seriously examine the State's role in a market economy. The question of the appropriate role for government became paramount, and pushed downsizing as a restructuring goal into a secondary position.

The reforms of the 1990s sought to strengthen government departments dealing with macroeconomic management, improve coordination, and enhance the Government's regulatory and social management roles while curtailing its microeconomic management role, especially in economic enterprises. The Government's role was identified as long-term planning, policy making, information gathering, organization and coordination, and providing services and oversight. The reforms also sought to clarify and rationalize relationships between central and local authorities to facilitate more local management of the economy and of society under the guidance of central policy. According to the Government's restructuring policy (Liu 1998), "Power should be divided rationally between central and local governments, the establishment of organizations should be coordinated, organization structures should be simplified, and personnel downsized to improve administrative efficiency." Changing the functions and scope of government was the central theme.

The policy has called for strengthening and expanding some government agencies, such as the SDPC, the SETC, and SAT. The Government also set up entirely new organizations, for instance, the China Securities Regulatory Commission, which regulates the stock markets in

Shanghai and Shenzhen; and the China Insurance Regulatory Commission, which plays a similar role in the insurance sector.

The policy also sought to move from the Government those primarily economic production functions that could be performed more efficiently outside of government. The policy “separating government from economic enterprise functions” called for decisions on such issues as product prices, personnel management, investment plans, market strategies, product lines, and the type and nature of foreign trade to be turned over to the enterprises themselves.<sup>17</sup>

Since the late 1980s the Government has corporatized some government departments that produced goods that could be sold in the market: the Ministry of Petroleum became the National Petroleum Corporation in 1988, the Ministries of Aviation and Space Industry became state corporations in 1993, and the Ministry of Electric Power became the State Power Corporation in 1997. In 1998 the Government launched a second big push to corporatize government agencies and in the process abolished 15 government ministries or commissions—in many cases turning over their planning and regulatory functions to the SETC.<sup>18</sup> During the course of these changes in 1998–2001 the number of State Council ministries and commissions was cut from 40 to 29.

The reforms to change government functions to suit a market economy have clearly been successful. Consider, for instance, the reform of the banking sector. In 1994, in anticipation of fundamental changes to the functions of the four major state banks, the Government set up new policy banks to invest in projects that were deemed to be necessary, but would not be commercially viable immediately. In 1995 the Law of the People’s Bank of China made this institution the country’s central bank, giving it new functions managing the monetary side of the economy. The 1995 Commercial Bank Law required the state banks to operate along commercial lines, a major departure from past practice. In 1998 each of the four main state banks set up asset management companies to handle nonperforming loans. All these changes reflect the Government’s determination to carve out a new role for the state better suited to a market economy.

Yet despite the many major successes, problems remain. Areas of responsibility for some government agencies, such as those responsible for telecommunications, continue to be unclear; multiple agencies continue to be responsible for the environment; and several ministries continue to share responsibility for agriculture and transportation.

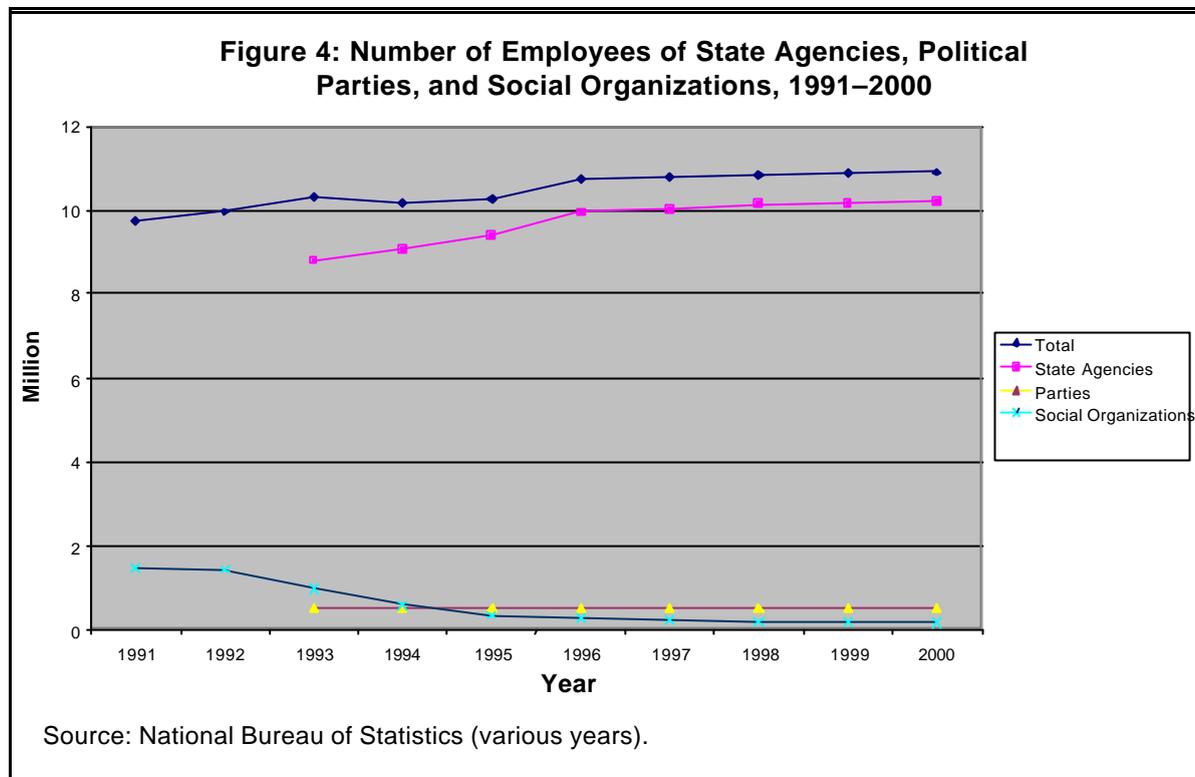
In addition, the reforms that sought to downsize the state have not been effective. According to the National Bureau of Statistics (NBS), the number of employees of state agencies (*guojia jiguan*) of all kinds increased throughout the 1990s, albeit at a slower rate since 1996, when the Government carried out two major downsizing campaigns (Figure 4). Data from the Ministry of Personnel also reveal that the number of civil servants has remained mostly steady, varying from about 5.2 million in 1993, 5.5 million in 1999, to 5.4 million in 2001. The number of employees has declined only in social organizations, such as associations. When

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<sup>17</sup> An important exception was that the state as owner of these enterprises would continue to appoint the managers of SOEs.

<sup>18</sup> These included ministries that managed electric power, coal, metallurgy, machine building, electronics, and chemicals. Ministries that manage internal trade, the post office, labor, broadcasting, movies and television, geology and mining, and forestry were merged with other ministries.

subnational governments are included, the number of employees nationwide has grown from about 24.6 million in 1991 to 28.5 million in 1999 (World Bank 2002).



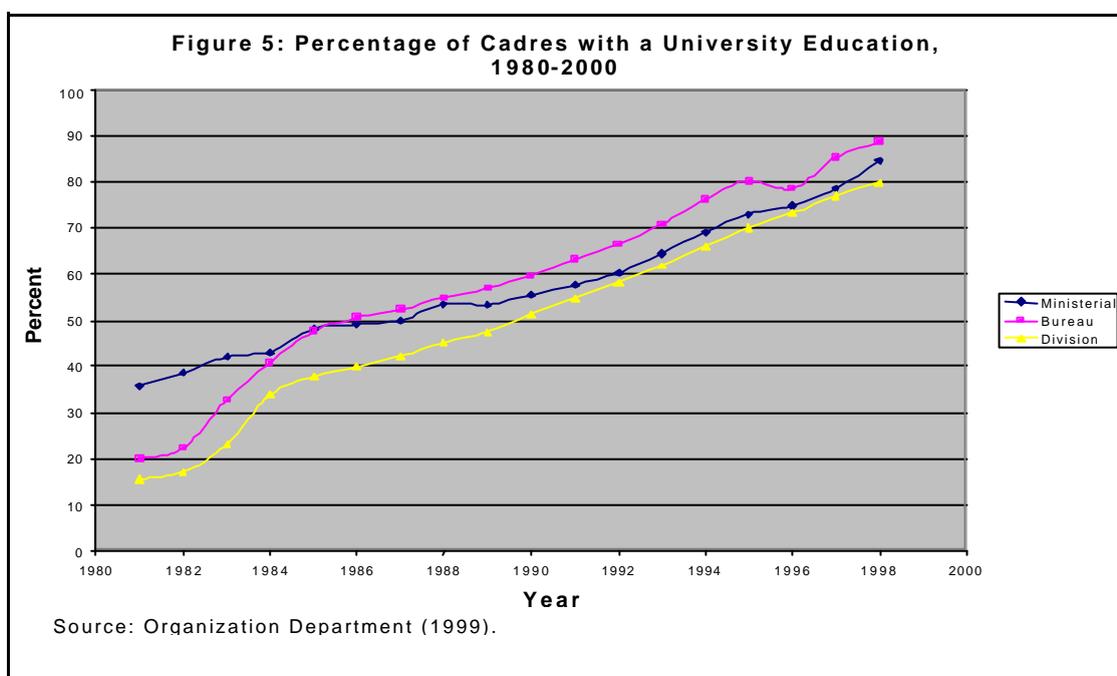
Because of high levels of overstaffing going into downsizing campaigns, the agencies were unlikely to achieve their ambitious targets. Moreover, in many cases officials designated for redundancy were simply transferred to other public organizations, especially to service units or institutions. Finally, in some cases authorities transferred those made redundant at the county level to jobs in towns and townships. Because of their extrabudgetary revenues, many local governments have been able to skirt the regulations requiring that they downsize.

In March 1998 the Government announced another vigorous campaign to downsize the bureaucracy, imposing a target of 50% reduction in the central Government. In 2001 the State Council announced that it had cut the number of its employees from about 32,000 to 16,000. In October 2000 the Government stated that cuts of about 47%, or 74,000 employees, had been made at the provincial level and that further cuts were being implemented at the prefecture, county, and township levels, making this the largest drop in the history of organizational reform. While anecdotal evidence indicates that large numbers of employees of many government agencies have been made redundant in the most recent campaign, it is still too early to determine the overall impact.

The restructuring campaigns of the 1990s were substantially different from prior campaigns. Nevertheless, there is still room for improvement to meet the objectives of sound development management. First, further efforts are needed to clearly identify the role of the Government and to remove overlapping and unclear lines of responsibility. Considerable work has been done in this area and it should be continued. Second, the pressure to downsize the bureaucracy should be maintained.

## 2. Civil Service Reform

As early as 1980 the Government recognized that the cadre system as it was then organized was a significant constraint to economic development.<sup>19</sup> The system had produced a cadre corps that, because of its age and lack of expertise, was ill-equipped to manage the development of the economy. Early reforms included the imposition of a mandatory retirement age (60 for men and 55 for women) for officials except for those at the highest ranks. Generous retirement benefits were stipulated for those who had “joined the revolution” before 1949. The new policies have dramatically lowered the average age of government officials from 1981 to 1998: the number of senior officials aged 60 or older dropped from 81% to 54%, and approximately one third of all senior officials at the county level and above are now aged 36–45, up from less than 10% in 1981. The cadre policy also emphasized that officials should be “young, well educated, professional, and revolutionary.” Implementing the policy has resulted in dramatic increases in education levels among senior officials (Figure 5). Nevertheless, of the civil service as a whole, less than half has a university degree (China Daily 19–20 January 2002). Better-educated and younger leading officials indicate an improved capacity in the bureaucracy.



Younger, more qualified officials now staff such key regulatory agencies as the China Securities Regulatory Commission, where in 2001 86% of employees had an undergraduate or postgraduate degree (Table 6). Seventy-eight percent of the Commission’s employees were 40 years old or younger.

<sup>19</sup> The cadre system, modeled on a personnel system used by the former Soviet Union, managed all white-collar workers (managers, administrators, and professionals) uniformly. No occupation-specific management regime existed for government officials, teachers, doctors, lawyers, geologists, engineers, accountants, and enterprise managers. All such workers were managed by the CPC’s Organization Department and Ministry of Personnel, as opposed to manual laborers, who were managed by the Ministry of Labor.

**Table 6: Education Levels of Employees of the China Securities Regulatory Commission, 2001**

	Male	Female	Total	Percentage of Total
Postgraduate Degree	169	42	211	61.5
Undergraduate Degree	67	17	84	24.5
Junior College	16	10	26	7.6
Specialized Middle School	2	2	4	1.2
Upper-Middle School	9	4	13	3.8
Junior-Middle School and Below	4	1	5	1.4
<b>Total</b>	<b>267</b>	<b>76</b>	<b>343</b>	<b>100.0</b>

Source: China Securities Regulatory Commission.

Since 1993 civil service reform has focused on improving the capacity and motivation of the bureaucracy through new selection procedures that emphasize openness and competition and more attractive compensation packages. Beginning in 1994, the central and local governments initiated advertising and filling civil service vacancies according to the new regulations. The selection criteria were published in local newspapers. Although the number of staff at the central level has dropped following the 1998 downsizing campaign, from 1994 to 1996, thousands of people applied for positions in the central Government using this channel. In 1994, 4,306 people applied for 440 positions; in 1995, 6,726 people applied for 490 positions; and in 1996, 7,160 people applied for 737 positions. Since 1994 provincial and local governments have also run similar recruitment campaigns for thousands of posts.<sup>20</sup>

Early competitions were limited to those who were legally resident in the province or capital city where the recruitment examinations were held. This meant, for example, that only those who were legal residents of Beijing could compete for positions in the central Government. This restriction was lifted in 1998, and the Government has arranged examinations for central government positions in eight cities around the country. The gradual moves to liberalize the household registration system will also permit more people to participate in the examinations.

Civil service reforms have encouraged members of ethnic minorities and women to apply for government positions. Civil service regulations require governments at all levels to give preference to applicants from minority ethnic groups in areas where they are prevalent. As a result of this policy, from 1981 to 1998 ethnic minorities have held a steady 7% of cadre jobs at the county level and above. They hold about half the senior government positions at higher administrative levels.

Although affirmative action is not official policy for women in the civil service, regulations encourage governments to hire more women; however, women still hold only about 14% of leading cadre positions nationwide. In 1996 women held about 19% of civil service positions. They held 7.3% of positions at the provincial and ministry levels, 7.5% of positions at the bureau

<sup>20</sup> In practice, local governments have been using advertisements and competitive hiring based on examinations since 1982 at the earliest, when they were no longer able to meet their staffing needs through the usual labor allocation system. Changes since 1993 have made such practices nationwide and compulsory for civil service posts.

chief level, and 11.3% of positions at the division chief level in counties. Many more women held positions in service units and institutions.

Since 1999 the CPC has adopted policies that are likely to encourage more people of diverse backgrounds to join the civil service (about 80% of civil servants are party members). President Jiang Zemin's "three represents theory"<sup>21</sup> seeks to expand the party's appeal. According to his theory, the CPC represents "advanced productive forces, advanced culture, and the fundamental interests of the overwhelming majority of the people." The President's 1 July 2001 announcement that businesspeople could now be recruited into the CPC is likely to see many more people with business experience joining the Government.<sup>22</sup> Recent moves by the China Securities Regulatory Commission and the People's Bank of China to hire senior staff from among highly qualified professionals from outside the mainland (mostly from Hong Kong, China) are indicative of a new emphasis on recruiting "the best."<sup>23</sup>

Civil service reforms also laid down new regulations for promoting officials. Promotions now require peer appraisals, and in many cases widespread consultations within an organization are mandated before a promotion to a senior position. The process is designed to improve transparency and reduce the chances of individual leaders selecting their protégés for promotion. Official policy now requires evidence of wide consultation and consensus among subordinates, peers, and other supervisors before promotions can take place.

Training for civil servants is provided through various means, including institutes of public administration set up by the State and party. At the apex of the system is the Central Party School, used to train people who are being groomed for ministerial-level positions, and the State Council's National School of Administration, set up to train senior officials who have joined the civil service from outside its ranks.<sup>24</sup> The authorities have set up a network of provincial-level cadre and public administration institutes, the best known of which are those in Shandong, Shanghai, and Shenzhen. Universities offer training for government officials in several public administration subjects. The best-known providers of such training are Peking University, the People's University, and Qinghua University in Beijing; Zhongshan University in Guangzhou; and Fudan University in Shanghai. Many civil servants also have had the opportunity to go overseas for short-term training.

In an effort to develop its human resources, the Government recently published the country's 2002–2005 training program for businesses, government, and research institutions. The National Program on Personnel outlines incentive mechanisms for professionals to move into the tertiary sector and encourages them to move from larger to smaller cities and to the western regions (People's Daily, English edition, 13 June 2002).

Remuneration for civil servants includes a base salary that is uniform across the country (adjusted for the local cost of living) and substantial benefits, such as housing and many kinds of subsidies. Salary scales are vertically compressed, with the gap between the highest and

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<sup>21</sup> Jiang Zemin is effectively still President until the People's Congress in March.

<sup>22</sup> Many CPC members have business backgrounds. They may have been workers or managers in SOEs when they joined the party, but were made redundant. They then went into business, retaining their party membership.

<sup>23</sup> In July 2001 the China Securities Regulatory Commission announced the hiring of Laura Cha Shih Meilung, former deputy chairman of the Securities and Futures Commission in Hong Kong, China, to become a vice chair of the commission.

<sup>24</sup> The National School of Administration has other functions also, including short training courses for more junior officials, and has recently been authorized to offer a master's degree in public administration.

lowest salaries being about 1:5.7 (1:23 in Hong Kong, China), compared with an international norm of 1:7 or more. Ministry of Personnel officials estimate that the real gap is much narrower, about 1:3, when benefits are taken into account. Bureaucratic rank matters mainly for the distribution of housing benefits and the use of automobiles. In recent years the Government has adopted a policy of monetizing more benefits, especially housing, which used to be provided to all officials working in government agencies.

Civil servants are evaluated annually, the results of which are used in promotion decisions. Although performance reviews are linked to pay, the link is relatively weak, because so few officials are classified as “basically competent” or “incompetent” during the appraisals. Thus most are eligible for performance-based pay increases.

The gap between the compensation of civil servants and those in the private sector is substantial, especially in the developed coastal areas. Comprehensive survey data for 1993 indicate that, on average, civil servants were earning about 26% less than managers of SOEs doing similar jobs. The largest gap occurred at the bureau chief level, with government officials earning 64% less than their SOE counterparts. If the private sector is included, undoubtedly the gap would be much greater, especially in the wealthier provinces. Indeed, Ministry of Personnel officials have estimated the gap in places like Shanghai to be about 100%. Nevertheless, as the recruitment data indicate, the relatively low salaries have not discouraged people from applying for government posts.

According to civil service regulations, salaries should be adjusted periodically, and they were increased in 1997, 1999, and twice in 2001. Accommodating these adjustments has been a fiscal hardship for poorer counties, where personnel emoluments may account for as much as 80% of total recurrent expenditure. Civil servants may also be given bonuses often financed out of extrabudgetary funds.

Mandatory retirement is now strictly enforced for all but the most senior officials, and the Government pays pensions to all retirees who were full-time employees. Because civil servants are now able to purchase their homes for a fraction of their market price, this provides some security for retirees.

Although there has been considerable progress in improving the capacity of the civil service, further improvements are required in the following areas:

- Buying and selling government positions, which have been widely reported in Anhui, Guangxi, Heilongjiang, Jiangsu, Jiangxi, Liaoning, Shanxi, and Zhejiang provinces since 1996, seriously undermine the meritocracy. Stamping out this practice is part of the PRC’s struggle against corruption.
- The education levels of government officials serve as a proxy for bureaucratic capacity. While dramatic progress has been made in raising the education and competency levels of leading officials, in many western provinces, especially Gansu, Ningxia, Qinghai, and Tibet, officials’ education levels are considerably lower than elsewhere. Significantly more investment in education and in-career training of civil servants is necessary.
- Monetizing civil service benefits will permit better-cost control. If civil service pay lags significantly behind pay in the nongovernment sector, motivation in the public sector

is likely to deteriorate. This is particularly likely in the more developed coastal areas. Relatively low pay levels also contribute to corruption.

### **3. Integrity in Public Service**

The Government has waged a vigorous campaign to maintain and improve the impartiality and integrity of public service. Both the law and civil service regulations require civil servants to be impartial and to execute their duties in accordance with the law. According to the Provisional Regulations on Civil Servants (Ministry of Personnel 1993, Article 6), officials must “abide by the Constitution, laws and regulations . . . execute their duties in accordance with the laws, regulations and policies of the state . . . and be fair and honest and work selflessly in the public interest.” To prevent possible conflicts of interest, the regulations prohibit civil servants from “engaging in trade, operating a business, or participating in other profit-seeking activities.”

To enforce the regulations, as of 1995 the authorities have required senior party and government leaders at and above the county level to declare their incomes. In 1997 the CPC issued new regulations that require leaders, their spouses, and their dependent children to report within 1 month on the following events: property transactions, weddings and funerals, marriage to foreign nationals, private trips abroad, business interests, and “other important matters that leading cadres themselves deem should be reported.” In addition, the spouses and children of government officials are banned from engaging in selected businesses. Some government agencies and local jurisdictions have established systems for auditing senior officials before they resign from their posts. To reduce opportunities for favoritism, civil servants who are related by blood or marriage are forbidden to work in the same government agency under the same supervisor and may not work for each other. Civil servants are also forbidden from “taking any action in the course of duty that affects the civil servant’s own interests or those of a close relative.”

A recent addition to the Criminal Law (Article 383) deals specifically with bribery and embezzlement and lays down severe penalties, including death, for those who take bribes or embezzle more than CNY100,000. Numerous government regulations, such as the Provisional Regulations on Administrative Penalties for State Personnel Involved in Graft and Bribery and the Regulation on Prohibiting State Personnel from Giving and Accepting Gifts in the Course of Doing Business Inside the Country, also seek to regulate official behavior (Chan 1999, p. 301).

In recent years the Supreme People’s Procuratorate has investigated a growing number of cases of corruption: reported cases of corruption increased from 20,000 in 1980, to 50,000 in 1995 and 83,000 in 2000. Procuratorial departments across PRC handled more than 200,000 criminal cases involving government officials since 1998, including 5,500 major cases involving bribery of misuse of public funds of over CNY 1 million (China Daily, 06 January 2003). The People’s 16<sup>th</sup> Congress in late 2002, endorsed the fight against corruption and signaled the Ministry of Supervision as a lead institution in leading the PRC’s anti-corruption efforts. The CPC’s Central Commission for Discipline Inspection indicate that between October 1992 and the first half of 2002, discipline inspection departments nationwide filed nearly 1.6 million cases and disciplined more than 1.5 million people. More than 259,000 people have been expelled from the Party for misconduct (China Daily, 4 Nov 2002).

Since the mid-1990s the Government has punished even extremely senior officials for corruption. The cases of Cheng Kejie, former vice chair of the NPC (see Box 3); Chen Xitong, former mayor of Beijing and Politburo member; Wang Baoshan, former vice mayor of Beijing; Hu Changqing, former vice governor of Jiangxi; Li Jiating, former deputy governor of Yunnan

Province, Cong Fukui, former deputy governor of Hebei Province, Li Jizhou, former vice-minister of public security, Mu Suixin, former mayor of Shenyang, Qin Changdian, former vice chair of the Chongqing Municipal People's Congress; and Wang Shihui, former vice chair of the Chongqing Municipal Chinese People's Political Consultative Conference and the former Chairman of the Everbright Group controlling the China Everbright Bank, indicate the Government's resolve to crack down on corruption. During 2000 the authorities reported that they had "disciplined" 21 officials of provincial or ministerial rank for corruption (New China News Agency 25 December 2000).

### **Box 3: Corruption at the Top—The Case of Cheng Kejie**

On 14 September 2000 the authorities executed Cheng Kejie, former vice chair of the NPC's Standing Committee, deputy secretary of the Guangxi Zhuang Autonomous Region's CPC Committee, and chair of the region's government, after finding him guilty of corruption. To date he is the most senior PRC official to receive such punishment. According to court reports he accepted bribes in cash and in kind of more than CNY40 million.

Officials uncovered Cheng's activities in the course of another investigation in Guangxi Province. Cheng made his money by ordering state-owned companies and government agencies to sell commodities and real estate at below market prices through his mistress, Li Ping, who resold them or received commissions on the sales and then remitted the "profits" to Hong Kong, China, where she had obtained permanent residency. Cheng also pocketed bribes for arranging promotions for officials. The going rate for a county deputy magistrate's position in Guangxi was apparently CNY288,000. In 1993 Cheng and Li had apparently decided that they would divorce their spouses and marry after they had accumulated enough money to support their lifestyle.

Source: New China News Agency (14 September 2000).

Despite the Government's efforts, corruption remains a serious problem. According to one study (Hu 2001, pp. 34–58), during the latter half of the 1990s corruption resulted in economic losses of 13.2–16.8% of GDP. A major component of these losses was tax fraud, which from 1994 to 1998 resulted in estimated losses of 7.6–9.1% of GDP. Government officials were involved in the most serious cases. The seriousness of corruption is revealed in the PRC's relatively low standing in Transparency International's corruption perceptions index, where in 2001 the PRC ranked 57<sup>th</sup> out of 91 countries. Moreover, from 1993 to 1998 fewer than half of the corruption cases being investigated led to criminal charges being filed, and only 6.6% of these led to corrupt officials being sentenced (Hu 2001). However, data for 1999–2000 indicate that the chances of being caught have improved somewhat.

The Government has adopted many policies aimed at containing corruption. First, local officials working in sensitive areas such as finance, auditing, and personnel administration are rotated at least once every 5 years to discourage corruption and promote impartiality. Second, new laws that require officials to tender all public works projects (the 1999 Bidding Law) and to use appropriate procurement procedures (the 2002 Government Procurement Law) are also designed to reduce opportunities for corruption by mandating open, transparent, and competitive bidding. Third, the Government's vigorous campaign to increase the transparency of government (see Box 2), especially at the town and township level, is clearly designed to

discourage corruption.<sup>25</sup> Fourth, the practice of publicizing the names of officials who are slated for promotion to give the public an opportunity to come forward with information about corruption or other wrongdoings has been effective in some provinces. For example, in 2000 in Jiangsu Province, after officials had announced the names of 6,000 officials slated for new appointments, the public protested against 203 of them. The Government investigated these cases and subsequently withdrew their appointments. At about the same time in Henan Province 113 officials were withdrawn after publicity, and 2 officials were turned over to the police for investigation of suspected criminal misconduct. Finally, local elections of delegates to village and town and township people's congresses provide people with an opportunity to throw out corrupt officials, and considerable evidence indicates that they have done so in some cases.

The Government's resolve to tackle corruption and integrity problems is not in doubt, but nevertheless, five additional steps need to be taken:

- Raising the salaries of civil servants, while it would not by itself eliminate corruption, would help combat the problem, as the relatively low compensation paid to civil servants contributes to some cases of corruption.
- Improving the environment for clean government is critically important. Significant steps in this direction have already been taken, but more can be done, especially by improving legislation to provide dissuasive sanctions for combating the bribery of public officials, approving money laundering legislation, strengthening investigative and procedural capacities by fostering interagency cooperation, and strengthening bilateral and multilateral cooperation in investigations and assuring conformity with international legal proceedings (extradition, support of international seizure, and the repatriation of forfeitable assets).
- Taking effective measures to promote corporate responsibility and accountability in-line with international standards, such as promoting internal company controls and transparency (books, records, accounts, financial statements); enforcing the elimination of the ability to claim bribes as tax deductions; enforcing penalties for the omission and falsification of information; and reviewing laws and regulations governing public licenses, procurement contracts, and other public undertakings.
- Taking effective measures to encourage public involvement against corruption by supporting NGOs that promote integrity and monitor public sector programs and by improving cooperation between the Government and private sector associations, chambers of commerce, labor unions, and the media.
- Permitting greater media freedom to receive and impart public information about corruption by establishing public reporting requirements to the justice system and implementing measures that increase the public's rights to access information.

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<sup>25</sup> Senior legislators are considering removing the rights of government departments under the State Council to create administrative licenses—a move designed to tackle the overuse of administrative licenses. There are currently 4,000 activities that require licensing at the national level. The draft law requires all documents needed to create a license to be standard and open to the public.

#### **4. Local Governance**

Although the PRC is constitutionally a unitary state and politically centralized, the extent of decentralization is quite extensive. Even under central planning, the PRC was much more decentralized than the former Soviet Union. Local governments are responsible for most public services, such as education, public health, social welfare, and the construction and maintenance of irrigation systems and most highways. The central Government is responsible for services such as railroads, post offices and telecommunications, defense, and external relations. The central Government provides local governments with grants to finance such major capital construction projects as interprovincial highways. Local governments must largely fund education, public health, and social welfare from their own resources. As noted earlier, this has placed a tremendous burden on poorer townships, counties, and provinces.

The PRC's civil service system is unified and national. Accordingly, local civil servants are subject to national regulations. Local jurisdictions prepare their own regulations that closely follow the national regulations. They also prepare local implementation plans for civil service reform. There is little variation in the content or timing of these plans.

Local government officials have virtually complete discretion on hiring staff. This has been a serious problem, especially for local branches of regulatory agencies such as the People's Bank of China. To reduce local influence in the banking sector, ADB shifted from a network of provincial branches to a network of nine regional banks, each of which covers several provinces. This practice and the firm control of the CPC's Central Finance Work Committee over personnel appointments have strengthened the hand of central authorities in relation to local governments in the financial sector.

The functions of local governments in such areas as providing public goods and services, collecting revenue and distributing local resources, implementing regulations, controlling land use rights, and encouraging investment and productivity highlight their important role in local economic development and the welfare of rural households. In this context, improving governance at the local level is becoming a key development challenge.

#### **5. Summary**

Since 1980 the Government has undertaken substantial restructuring of the government and reform of the civil service. These policies have changed the State's role to one that can better serve a market economy. The authorities have increased the capacity of the government workforce and moderated certain bureaucratic irrationalities somewhat. Nevertheless, government employees are still relatively poorly paid and corruption continues to be a serious problem.

One of the most significant challenges in the medium term will be to improve local governance capacity so that local leaders are better able to promote policies, improve resource allocation, increase investment, facilitate more efficient markets, and improve service delivery and rural living standards. To this end, broadly based training programs that strengthen the governance skills of local community leaders will be critical to development in the next decade.

#### **C. Reform of the Legal, Judicial, and Regulatory Systems**

A sound legal system is one where the rule of law is the norm. Such a system treats the state as just another actor, has predictability and consistency of laws, has well-trained officials

who exercise their powers impartially, and is characterized by effective and impartial enforcement of the law and execution of judicial decisions. The PRC's legal system does not meet these criteria.

One of the greatest challenges facing the PRC's legal system is reforming it to meet the needs of a market economy. The process not only requires writing numerous new laws, but setting up new institutions. Reforming the legal system presents an immense human resource development challenge that requires training millions of judges, lawyers, and others involved in the legal profession. This is a major challenge, especially in the context of the gradual evolution over centuries of legal systems in other countries. Reform also involves inculcating a respect for the rule of law throughout society. The PRC has made significant progress on all these fronts during the past 20 years; however, further progress is needed in many areas.

- Years of legal reform have increased the numbers of laws on the books, but overall the State is less bound by the law than ordinary citizens or nonstate institutions.
- There are some inconsistencies in the laws and a certain degree of arbitrariness is apparent in the legal system.
- Because local courts are financially dependent on local governments, judicial localism is a problem.
- Although the number of lawyers has increased dramatically in recent years, there is still a shortage. Training for lawyers and judges also needs to be improved.
- An effective system for resolving jurisdictional disputes among competing regulatory agencies is lacking.
- An effective system for periodic review of the extent to which previously secret regulations may be made public still does not exist.
- Because local regulatory bodies depend on local governments for funding, some are inclined toward local protectionism.
- A system requiring regulators to consult with regulated entities in drafting new or revising old regulations is not institutionalized.
- Government agencies still do not have comprehensive procedures for making and applying rules to govern their operations.

## **1. Legal Framework**

According to the 1982 Constitution the PRC is a country bound by law. Article 5 states as follows: "All state organs, the armed forces, all political parties and public organizations and all enterprises and institutions must abide by the Constitution and the law. All acts in violation of the Constitution or the law must be investigated." Moreover, "No organization or individual is privileged to be beyond the Constitution or the law." These provisions are clear and self-explanatory.

Reforming the legal system has substantially progressed during the last 2 decades. The volume of legislation and regulation has grown rapidly. From 1979 to mid-2000 the central Government promulgated 311 new pieces of legislation, 700 sets of regulations, and more than 4,000 sets of administrative rules. Moreover, from 1980 to mid-1999 provincial governments promulgated or approved 7,448 local laws and regulations. The pace has continued, and in the fourth quarter 2001 and during part of 2002 alone the NPC and its Standing Committee passed 44 major laws and regulations (Appendix 2). The PRC's entry into the WTO has accelerated the process of adapting the country's legal and regulatory systems. According to the Ministry of Foreign Trade and Economic Cooperation, as a result of the PRC's entry into the WTO, approximately 2,200 laws and regulations have to be modified or repealed, and by March 2002 a list voiding nearly 600 of them had already been published. The Ministry of Justice has arranged for training courses for law professionals on the WTO, underlining the importance attached to developing highly competent lawyers versed in the WTO rules and "internationalizing" its legal system.

From 1986 to 2002 the number of law offices increased from 3,198 to more than 10,000, while the number of lawyers rose from 21,546 to more than 120,000. Of these, the number of full-time lawyers grew from 7,491 to 61,761 during this period. More than 109 foreign law firms and 40 Hong Kong law firms have set up representative offices. By 1999 more than 238,576 organizations had full-time legal advisors, up from 59,478 in 1986. In 1999 lawyers provided legal advice in thousands more cases than they did only little more than a decade ago (Table 7). Statistics from the Ministry of Justice indicate that more than 20,000 legal experts and lawyers currently serve as consultants to various levels of government.

**Table 7: Numbers and Types of Cases Where Lawyers Gave Legal Advice, 1986 and 1999**

Type of Case	1986	1999
Civil Cases	208,627	592,455
Economic Cases	—	426,358
Criminal Cases	154,485	309,767
Administrative Cases	—	39,006

Source: National Bureau of Statistics (1989, 2001).

The popularization of the law and the importance of legal knowledge in decisions about promotions are also increasing. A case in point is a May 2002 circular issued by the Ministry of Justice and the China Central Committee urging officials to study the law. More than 190,000 officials above the midlevel rank received legal training between 1996 and 2000 (China Daily 6 June 2002). Clearly a system of rule by law is being institutionalized; however, well-trained lawyers are in short supply: the Government estimates that at least 150,000 are needed nationwide, which is still only one lawyer for every 86,000 people.

To solve disputes, the PRC relies less on lawyers and formal court proceedings and more on mediation. In 1999 approximately 55,000 judicial assistants were assigned to help with mediation work carried out through 970,000 mediation committees that relied on the services of 8.8 million mediators. People's mediation committees exist at the neighborhood level and sometimes at the work unit level. While they were significant in the era prior to economic reform, their current significance is unclear. Court-assisted mediation is also possible and encouraged. In 1999 people's mediation committees handled 5.2 million civil disputes, down from 7.3 million

in 1986. This seems to indicate that people are now more willing to go to court to solve civil disputes than in the past, which may suggest that people have more faith in the efficacy of the judicial system in handling civil disputes or that they have more resources to devote to dispute resolution. Similar data are not available for other types of disputes.

#### **a. Officials, Legislators, and the Law**

The PRC's legal system provides that all citizens are equal before the law. Thus as a matter of formal law, politicians and officials have no officially sanctioned immunity from normal civil and criminal laws. They do, however, have certain procedural protections. For example, the appropriate level of court for trying government officials in criminal and noncriminal cases is determined in part by their rank. This is because the court system functions as a regular part of the bureaucracy, and within this system it is inappropriate for an official of lower rank to exercise power over an official of higher rank.

As a matter of formal law, legislators have certain protections against legal proceedings, but these protections are not extensive. NPC delegates may not be arrested or sentenced for criminal acts without the approval of the NPC presidium when the NPC is in session and without the approval of the NPC's Standing Committee when it is not. Note, however, that arrest is a formal step in the PRC's criminal process and does not cover all types of detention. NPC delegates may be detained for various reasons by the police without the foregoing authorization, but the police must still notify the NPC presidium or the Standing Committee depending on whether or not the NPC is in session. Similar protections exist for delegates to local people's congresses at and above the county level, and authorization for an arrest must be obtained from the presidium or the standing committee at the corresponding level. Delegates to the NPC and to local people's congresses are also exempt from legal liability for anything said or any vote cast during sessions.

#### **b. Complaints and Redress**

According to the Constitution citizens have the "right to make to relevant state organs complaints or charges against, or exposures of, any state organ or functionary for violation of the law or dereliction of duty" (Article 41). Thus there are no legal barriers against anyone lodging a complaint against a politician or an official. Indeed, from time to time the authorities have set up hotlines and e-mail addresses to receive such complaints. The issue is less one of whether citizens can report illegal behavior by government officials than one of what will be done with such reports once they have been submitted.

Although the PRC has no ombudsman or equivalent, the PRC law and political custom provide various avenues for redress in case of maladministration. The traditional avenue of redress has been a complaint to the administrative superior of the official or organization in question through letters and visits. Many government departments have established bureaus specifically designed to handle such complaints. Another avenue of redress is to seek formal review of the action in question within the bureaucracy. Such actions are governed by the Administrative Reconsideration Law, which permits citizens, legal persons, and "other organizations" to request that the regulations and administrative actions of State Council agencies, county and higher-level local governments, and town and township governments be reconsidered. From 1991 to 1997, 220,000 cases were reconsidered nationwide, or an average

of 30,000 cases per year (Ying and Yuan 2001, p. 295). From 1991 to 1998, 50% of challenged administrative regulations or actions were upheld, 20% were abolished or rescinded, 10% were changed, and the remaining cases were withdrawn. The vast majority of cases, 70%, involved the administrative regulations or behavior of public security agencies, and most occurred at the county level. From 1991 to 1998, for example, while county governments were either plaintiffs or defendants in 10% of the cases, county-level departments were involved in 55% of the cases. Municipal governments were involved either as plaintiffs or defendants in 7% of the cases, while their departments were involved in 23% of the cases. Provincial governments and the State Council were involved in only 5% of the cases (Ying and Yuan 2001).

Citizens may challenge government actions through the Administrative Litigation Law; however, the scope of actions available under the law is limited. A complainant cannot, in general, challenge the lawfulness of a particular set of regulations, but may challenge only an alleged misapplication of such regulations.

### **c. Citizen Oversight**

Oversight functions within the bureaucracy are generally exercised by higher-level government bodies. The PRC does not subscribe to a system of independent citizen oversight of government operations. In those cases where oversight is exercised by CPC disciplinary bodies or the procuratorate, the authority is still exercised by full-time government or party officials and not by ordinary citizens.

The courts have a system of people's assessors (*renmin peishenyuan*), ordinary citizens who hear particular cases alongside judges, and whose task is to ensure some kind of popular voice in, and supervision over, the functioning of the courts. In practice, however, people's assessors are not expected to play an independent role in hearing cases.

## **2. The Judicial System**

The PRC does not have a regular bureaucratized judiciary on the continental European model. Judicial appointments are based on numerous criteria, of which merit-related factors, such as level of education or experience, are but one consideration. Political factors are also taken into account. This system of judicial appointments and promotions needs to be more transparent.

The Law on Judges (1995) sets forth certain criteria for judges, which in practice apply only to new judges, not retroactively to sitting judges. No experience as a lawyer is necessary; judges are more akin to civil servants, and being a judge is viewed as different from being a lawyer. While the law sets forth formal qualifications for the first time, these do not include a law degree, but only "specialized knowledge of the law" (who is to determine whether a potential judge's knowledge is sufficient is not clear). The Law on Judges also mandates requirements for work experience of 1 or 2 years in some cases. Although the type of work is not specified, it may mean some kind of work in a court, for example, as an assistant judge.

Continuing training for judges is available and is an important part of the Government's training program for judges, especially as the new qualifications set out in the Law on Judges are typically not applied to sitting judges. Instead, sitting judges are supposed to bring themselves up to standard through continuing education programs.

Judges do not have tenure, and judges have been removed for many reasons, from incompetence to making decisions unpopular with the authorities. They are viewed as a type of civil servant, and can be fired.

Judges and court officials are also treated as civil servants in terms of pay. Although judicial independence under the leadership of the CPC is respected, there is no pay system designed to ensure their neutrality and independence. Compensation for the judiciary tends to be lower than for lawyers, a gap that is quite substantial in the cities. Judges are permitted to earn money through work unrelated to law, such as writing books, but cannot engage in work that would present a conflict of interest. Like civil servants, judges, prosecutors, and the police are forbidden to engage in business activities.

Mobility between the judiciary and the bar is virtually nonexistent. Hardly any lawyers become judges, and those judges who become lawyers typically are valuable to their firms, not only because of their legal knowledge, but also because of their knowledge of the functioning of courts.

The police, like the courts, are administered by local governments at various levels. The expenses of the Ministry of Public Security are paid for out of the central Government's budget, but officers of the Beijing Public Security Bureau, for example, are paid by the municipality of Beijing. The power to remove high-ranking police officers is vested in the courts and the bureaucracy, not in an independent agency; however, as the case of former Vice Minister of Public Security Li Jizhou indicates, this system without any independent agencies is nonetheless able to remove even senior police officials who break the law.<sup>26</sup>

According to Article 126 of the Constitution, "The people's courts exercise judicial power independently, in accordance with the provisions of the law, and are not subject to interference by any administrative organ, public organization, or individual." This should be understood within the context of the PRC's political system, whose Constitution explicitly acknowledges the leadership of the CPC.<sup>27</sup>

The impartiality and efficiency of the judiciary can be considered by examining the processing of cases. A case comes to a court in several ways. Criminal cases come to particular courts because the procurators decide to bring them there. Civil cases come to whatever court plaintiffs bring suit in. The appropriate level and location of the court depends on the facts of the case and the law involved. More important cases will be heard by higher-level courts. If a court believes that it does not have jurisdiction or that hearing the case is otherwise inappropriate, it will decline to hear the case and will generally advise the plaintiff or procurator where to take it. A higher-level court may, at any time, take jurisdiction over a case out of the hands of a lower-level court and hear the case itself. It may also transfer cases before it to a lower-level court.

Once a case is before a particular court, the court determines which judge or panel of judges should hear the case, a decision where the views of the court president figure

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<sup>26</sup> Li was sentenced to death, suspended for 2 years, for his role in the Yuan Hua smuggling case. He was convicted of accepting bribes of more than CNY5 million and other offenses (*Wenhui bao* [Hong Kong, China] 23 September 2001).

<sup>27</sup> As we were told in an interview at the Supreme People's Procuratorate, held in preparation for this report, "Under the leadership of the CPC, the courts exercise judicial independence."

prominently. The assignment to a particular judge or panel of judges does not mean that they will be the ones who will make the final decision. Any case is potentially subject to being decided by the court's adjudication committee, the highest decision-making body within the court. Adjudication committees are headed by a court president and are made up of senior judges. They can have the judges hearing any particular cases they deem important to report to the committee, and can then decide how to handle the case. The judges assigned to the case must implement the committee's decision and sign the judgment. While not without its defenders, legal scholars in the PRC have leveled considerable criticism at the system of adjudication committees.

Typically, the courts are supposed to process various kinds of legal actions within a specified time; however, no particular consequences generally follow if they do not do so. A judge who consistently violated such time limits without an acceptable reason would probably be disciplined administratively.

While the courts' ability to enforce their judgments is improving, they have occasionally reported difficulties. In March 1998, for example, the head of the Guangzhou Municipal Court reported that during 1997 the court's verdicts were not carried out in more than 6,000 cases, an increase of 31% over the previous year (Guangzhou Daily 31 March 1998). This sometimes happens because the defendant in a contract case is a powerful government department whose rank is higher than that of the court and its officials. Property rights cases may also be difficult to enforce if the defendant is a powerful government department.

A large number of what would elsewhere be minor criminal cases (for example, petty theft) never get to court in the PRC system. They are instead dealt with as "administrative offenses" subject to determination and punishment by the police. Supposedly such determinations can be appealed to the courts, but in practice this rarely occurs. The courts are reserved for relatively serious violations of the law, and only such violations are formally labeled as crimes. Even then, a court does not usually make the substantive determination of guilt or innocence, but is rather the last stage of a long process of investigation and determination of guilt. The speed of this investigative process varies depending on the case, and is not necessarily longer the bigger the case. During various "strike hard" campaigns against crime, newspapers have reported murder where the time from the commission of the crime to the execution of the convicted suspect was about a week.

The courts in the PRC, like those in most other countries, move slowly, especially in civil cases, which can take years. Following judgment, execution of the judgment may also take some time, again, perhaps years, if the defendant is unwilling to comply voluntarily. Understandably, long delays are more likely in cases involving large amounts of money and large, influential enterprises.

Like the poor in other societies, poor people in the PRC probably have more difficulty accessing courts and the legal system, even though they are entitled to legal aid. Many potential litigants choose to have their cases mediated through the officially established mediation system, which operates as an effective dispute resolution mechanism. Compared with the courts, cases that are handled through mediation tend to proceed more speedily and at lower cost and to result in outcomes that are enforced more effectively.

The adequacy of the court infrastructure tends to depend on the location of the court and the wealth of the local government on which it depends, and courts as a whole need to be better funded. Courts in cities such as Beijing or Shanghai are relatively well equipped and have

adequate facilities. Courts in poor, rural areas may not even have a proper courtroom. The court infrastructure is intimately tied to local financing. Because budget allocations from the Government are insufficient to cover their costs, court fees are an important source of revenue for the courts; however, including court fees in the budget would increase transparency.

### **3. Regulatory Regimes**

An effective regulatory regime should be transparent; operate on a level playing field; be institutionalized, and therefore predictable; and include an efficient system for resolving ambiguities and inconsistencies once they become apparent. The real problem in the PRC's administrative law is not one of too much regulation, but of overlapping and sometimes contradictory jurisdictional claims by different bodies, with no effective system for resolving these claims.

#### **a. Current Situation**

As a result of the Government's decision to replace central planning with a market economy, the PRC has witnessed explosive growth in the amount of regulation. Since 1979 the central Government has promulgated 700 sets of regulations and more than 4,000 sets of administrative rules. From 1980 to mid-1999 the provincial governments promulgated or approved 7,448 local laws and regulations.

Government departments with jurisdiction over the issue in question typically administer government regulations. Such departments often issue the regulations, sometimes with unclear authority to do so. For example, regulations relating to environmental protection are issued and enforced by the Environmental Protection Bureau, which also enforces laws and regulations relating to environmental protection issued by superior bodies, that is, the State Council, the NPC, the NPC's Standing Committee, and the State Environmental Protection Bureau. Improvements are being made however. At their 28<sup>th</sup> meeting the Standing Committee of the 9<sup>th</sup> People's Congress endorsed the Clean Production Law that strengthens the current fragmented environmental legislation and execution system, with an interagency and interdisciplinary approach from State Council to local government responsibility.

Government regulations are generally comprehensible in that a reader without specialized legal training will often understand their intent. This is not necessarily, however, a virtue in regulations. A regulation can be clearly written and yet still leave a great deal of discretion to the government agency in charge of administering it. In some cases this makes it difficult for regulated entities to know in advance what is permitted and what is not. In addition, a comprehensible regulation may still leave considerable room for confusion if it treats a subject illogically or inconsistently with another law or regulation.

The problems of lack of clarity or consistency in government regulations stem not from the wording of the regulations themselves—in any large government, different bureaucracies are bound to issue regulations that at times may be unclear or inconsistent—but from the lack of a well-functioning system for resolving ambiguities and inconsistencies once they become apparent in practice. The problem of ambiguous and conflicting ministry-level regulations, for example, can be resolved only through top-down action from the State Council, not through bottom-up action initiated by regulated parties and pursued through the courts or other institutions.

Government regulations are becoming increasingly accessible to users. The legal publishing industry is flourishing, and several agencies like the China Securities Regulatory Commission have made a conscientious effort to post regulations and notices on their Web sites. Nevertheless, a culture of secrecy continues to pervade the legal and regulatory system. Regulations are made public not because the public has a right to see them, but because the agency in question believes that its work will be facilitated by publicizing them. Internal regulations and practices continue to play a major role in the workings of government agencies. In some cases, as in other countries, an organization might have a legitimate need for confidentiality in relation to some of its procedures. In other cases the rules are kept secret for less legitimate reasons: to allow the administering officials more room for flexibility in deciding when to permit exceptions, for example, or because revealing them might be embarrassing for the Government. The Government should continue to improve transparency by making more rules and regulations publicly available.

#### **b. Funding for Regulatory Bodies**

Regulatory bodies are not fully funded from the national budget. A large number of regulatory bodies exist at the central level and at various local levels. The central-level bodies tend to be responsible for policy making, while the local-level bodies tend to be responsible for enforcement. In general, the local-level bodies are part of local government and local officials are responsible for them; for example, they control the bodies' funding and personnel, and the bodies are not subordinate to their functional counterparts at the next level of government. At each level of government, regulatory bodies typically depend on a combination of budgetary support and fees. National budgetary support for regulatory bodies is usually only provided to that body's central-level organization, and even then accounts for only part of its funding. Local-level regulatory bodies typically receive no national budgetary allocations.

Two results follow from this funding structure. First, those regulatory bodies that are chiefly responsible for enforcement work are effectively subordinate to local government, and cannot be expected to function effectively if their mission is at odds with local government priorities. Second, to the extent that they are financially dependent on fines for regulatory violations, regulatory bodies have an interest in seeing violations continue.

#### **c. Scope of Regulation**

Regulatory bodies may be found in most areas of the economy, including banking, insurance and finance, securities and stock exchanges, consumer protection, public utilities, environmental protection, corporate governance, and the media. Professional associations are not regulated by regulatory bodies but by the Government's administrative department in charge of that particular realm of social, political, or economic activity. For example, the Ministry of Justice is the ultimate regulator of the legal profession, and thus the All-China Federation of Lawyers falls under its auspices. There is often an internal party body with authority over a particular subject that exercises some regulatory power, sometimes directly and sometimes indirectly through government bodies.

Government regulatory bodies typically take the form of a ministry, commission, or bureau under the State Council (or a body subordinate to one of these). They are ultimately accountable to the State Council. The CPC plays an important role in the overall supervision of regulatory bodies. Key sectors are regulated by the following bodies:

- **Banking and finance.** People's Bank of China, MOF.
- **Insurance.** China Insurance Regulatory Commission.
- **Securities and stock exchanges.** China Securities Regulatory Commission.
- **Competition and consumer protection.** No body is specifically charged with promoting competition as such. Various bodies are responsible for enforcing commercial laws and regulations—including laws relating to competition and consumer protection—including the State Administration of Industry and Commerce and the State Drug Administration.
- **Public utilities.** No single body is in charge of public utilities. The State Economic and Trade Commission supervises electric power, while the Ministry of Construction supervises the management of water and sewerage (except in relation to environmental protection).
- **Environmental protection.** State Environmental Protection Bureau.
- **Corporate governance.** No body is specifically charged with overseeing corporate governance, although the China Securities Regulatory Commission and the State Administration of Industry and Commerce play a role in this area.
- **Professional associations.** No body is charged with regulating professional associations, although all such associations are regulated by some government body.
- **Media.** Communist Party Publicity Department; State Administration of Radio, Film, and Television; State Press and Publications Administration.

The prices of many utilities and public services are not determined by the market, less because the Government regulates the prices than because most utilities and services are delivered by local governments, and thus provincial economic and trade commissions and local price bureaus play a regulating role.

The Price Law specifically contemplates government-regulated pricing of merchandise that is "of great importance to the development of the national economy" or to scarce resources, natural monopolies, and important public utilities and services. Such price setting could take place at the central or the local level of government, and is generally under the jurisdiction of the Price Bureau of the SDPC (and local price bureaus under local development planning commissions).

The central Government may have policies with which local governments do not comply. A recurring problem, for example, is levying various unauthorized fees on enterprises by local governments for the delivery of various services, including services that are supposed to be free, such as public security. The fundamental dilemma the central Government faces is that while local governments must be allowed to raise funds for themselves to some degree—as the center cannot finance all their needs—local governments sometimes abuse that fund-raising power. The central Government cannot effectively supervise this, because superior levels of government simply do not have the resources to decide in every case what kinds of fees are

legitimate and genuinely justified and what kinds are not. At the same time supervision from below as in making local governments accountable to local people through direct elections of officials or other means is not politically acceptable.

#### **d. Transparency and Accountability**

As a rule public agencies do not disclose information about their regulatory actions, and such information is not considered public. Thus regular reports with financial statements are not published for public information, although the agencies must report on their activities to superior bodies.

Those regulations that are made public are published in Mandarin, a language understood by virtually all educated people in the PRC; thus language is not an issue. Transparency has increased considerably over the last 2 decades, but in some cases certain regulations remain secret and will not be released to inquirers. Some government officials continue to have an attitude that is hostile to the basic principles of transparency: they believe that to reveal regulations or their department's interpretation of regulations is to reveal valuable proprietary information that could later be used to their disadvantage. Some officials refuse to respond to inquiries from lawyers as to the meaning or interpretation of certain regulations or policies, apparently on the grounds that the lawyers are in the business of making money from this information and that it would be improper to assist them in this commercial endeavor. Still other officials refuse to deal with inquiries from foreigners, and insist that inquiries come from PRC citizens. All this is consistent with the view that information—even information about government policy and regulations—is a valuable commodity that should be released only with the greatest care rather than generally being available to all.

#### **e. Redress Mechanisms**

Citizens can challenge administrative actions through an administrative appeal within the government department responsible for the action. Such actions are governed by the Administrative Reconsideration Law. They can also challenge government action through the Administrative Litigation Law; however, the scope of actions under that law is limited. A complainant cannot, in general, challenge the lawfulness of a particular set of regulations, and can only challenge an alleged misapplication of those regulations. There is not generally a requirement for exhausting administrative remedies prior to seeking relief in court.

Injunctive relief is not generally available in the PRC's legal system. Financial compensation for damages caused by improper government action can be sought through a suit brought under the State Compensation Law, which the NPC enacted in 1994 to provide individuals and legal entities with the right to obtain compensation for harm caused by illegal acts of government entities. The law provides different procedures and standards for obtaining compensation from administrative entities and from organs of the criminal justice system, such as the courts and procuratorates. In both the administrative and criminal compensation contexts claimants must apply for compensation to the state entity that allegedly violated their rights. The law provides for several appeals to higher-level entities and, in the administrative compensation context, allows claimants to bring their claims in the people's courts if they are unable to obtain redress at the administrative level. Final appeals of criminal compensation applications are filed with a special compensation committee of the people's courts. In practice, the implementation of the State Compensation Law has encountered some difficulties. The number of cases filed has

been limited, and some government officials have exploited loopholes in the law to avoid paying compensation. Nevertheless, the statutory recognition of the right to compensation and the promulgation of detailed procedures for obtaining such compensation is an important step in establishing limits to improper state actions and providing individuals and entities with a mechanism for challenging such actions.

#### **f. Efficiency and Effectiveness**

Although the number of regulations for a market economy has increased substantially in recent years, characterizing government regulation as either increasing or decreasing is difficult, as the character of government activity is changing. In the era of the planned economy, government entities directly carried out activities that are typically regulated in a market economy, for example, steel production, which in market economies is subject to rules on industrial safety,<sup>28</sup> pollution, zoning, and so on. If a powerful ministry decided to site a factory somewhere and to pollute that area, there was little anyone could do about it. Such activities were simultaneously highly regulated—in that nongovernment entities simply could not engage in them—and not regulated at all—in that they were not subject to a uniform set of rules. As the PRC moves toward a more market-oriented economy with less direct government operation of industry and commerce, a necessary concomitant activity is increasing the number of rules designed to regulate nongovernment entities engaging in business. On the whole, the trend in regulation is toward allowing more leeway to nonstate actors and to market forces, even if the volume of regulations is increasing—in that more regulations are being promulgated than are being repealed.

Public hearings on regulatory proposals are voluntary on the part of agencies, and there is no requirement for such hearings.

The issue of utility regulation is more complex. Typically utility services are delivered by local government entities or quasi-governmental bodies. These are subject to rules and policies about how much they can charge; however, they may be able to avoid these rules by charging numerous unauthorized fees ostensibly for other kinds of services. Because of their monopoly over the service in question, they can force users to accept these charges. For example, a municipal waste disposal utility, while respecting the limits on service fees, might require users to rent trash bins from it at an above-market rate.

For private entrepreneurs wishing to start businesses, the regulatory environment is still burdensome, and in some cases not transparent—getting a clear understanding from official sources of all the necessary regulations that they must comply with is sometimes difficult. Would-be entrepreneurs must usually obtain numerous licenses and permits, especially in sectors with substantial government involvement. Sometimes government bodies fear competition and use their administrative powers to stifle them. In a survey, private businesses identified the need for government permits as a major barrier to market entry.<sup>29</sup> The Administrative License Law, being considered by the NPC, may go some way toward solving and reducing these obstacles to the business sector.

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<sup>28</sup> The June 2002 approved Work Safety Law, which outlaws threats to workers' lives, is the responsibility of the State Economic and Trade Commission's Bureau of Work Safety.

<sup>29</sup> ADB-sponsored survey of 756 private firms carried out in five cities (Beijing, Nanhai, Shenyang, Wenzhou, and Xi'an) by the Tsinghua University in collaboration with the All-China Federation of Chambers of Commerce in September 2001.

The regulatory process does not really need streamlining as much as it needs regularizing. In other words, it requires order, transparency, and predictability—all needs identified by private firms (ADB-sponsored survey). Although the PRC has a law on administrative litigation governing lawsuits against government bodies, it does not have a basic law or set of procedures governing the operations of government bodies, in particular, their activities in making and applying rules, such as the Administrative Procedure Act of the United States. Some major initiatives to draft such a law are currently under way, but this is a complex undertaking and the ultimate passage of such a law is not expected for several years.

#### **g. Quality**

The quality of regulation varies considerably. Different parts of the Government issue regulations of different quality. One of the chief problems with regulations is that they are often designed more to empower the agency issuing them than to provide reliable guidance to regulated entities. Thus they often contain catch-all clauses allowing the regulator to add requirements at will, and typically give the power of interpretation to the same body that issued the regulations.

A further problem with regulations is that the issuers often do not consult with the regulated entities to determine if the regulations make sense or are enforceable. An example is the set of regulations issued in 2001 imposing various requirements on the users of encryption software. Encryption is a standard part of common software such as Microsoft Word, and implementing the requirements as written would have been impossible. A period of notice and comment would have been sufficient to reveal this problem. In another example the Beijing Bureau of Justice, without advance consultation, issued regulations requiring foreign law firms in Beijing to install software supplied by the bureau on their computer systems and to pay a fee for it. The firms objected strenuously, and eventually the bureau agreed that while it would not actually withdraw the regulations, it would not enforce them. As a result, an ill-conceived set of regulations is still ostensibly on the books, but subject to an informal agreement not to enforce them. Practices like this greatly undermine the quality of regulations and of the entire practice of regulation.

There is no general system of time limits for responses to requests for government action. Each particular license or action is governed by a particular regulation that will set forth the time limit for approval. Sometimes failure to respond within the stipulated time limit means that the application is deemed approved, but sometimes agencies may require an appropriate approval document from the first agency to issue their own approval, and a deemed approval does not result in the issuance of an approval document. Occasionally no clear consequences are specified for an agency's failure to respond within the stipulated period. In a recent case an applicant for listing on the stock exchange sued the China Securities Regulatory Commission on the grounds that it had not reached a decision within the legally stipulated time. The court found for the plaintiff and ordered the commission to review the application and issue a timely decision.

## **h. Property Rights and Contracts**

Economic entities may enter into transactions, sign contracts, have disagreements, and win or lose lawsuits much like private parties. The enforceability of contracts depends a great deal on the identity of the contracting parties and the nature of the obligation. Because courts are under local control, enforcing contract rights against a powerful local enterprise can be difficult. The difficulty lies not in a failure to define contract rights adequately, but rather in the weakness of the courts relative to other institutions. Contracts between parties are rarely detailed. This probably reflects a belief that spending time and money to negotiate a detailed contract is not worthwhile when disputes are unlikely to be resolved based on a skilled legal interpretation of the contract.

The state or collective organizations (in effect, local government units) own all land in the PRC. This ownership is similar to a fee simple in English law. Other parties can own lesser interests in the land, some of quite significant economic value, including long-term leasehold interests. The PRC has a system for registering these lesser interests in land, but it is not always reliable. One source of confusion is the continuing distinction between interests in buildings and interests in the land underneath the buildings. Although such interests are always supposed to be transferred together, mistakes can occur. On the whole, however, the system appears to provide sufficient assurance for real estate development to occur in the cities.

In rural areas most land is classified as collectively owned. This means that the right to grant lesser rights to the land belongs to some unit of local government, broadly defined to include, for example, village authorities, which are not officially considered as government bodies because village officials are not state cadres. Unfortunately, the relevant law does not clarify which unit of local government is the legal owner, contenting itself with the vague "farmers' collective."

Because government units still carry out a great deal of economic activity, uniform enforcement of various regulations remains difficult. It is difficult for one government unit to enforce its policies against another, and disputes between government units are typically resolved by the common superior, not by the courts or other third-party arbiters. Enforcing regulations against private parties is also hard because of corruption and agencies' need to rely on fines, which means that it is to their advantage to allow continuing violations so that they can continue to collect fines.

Overall, the regulatory regime is not transparent. The public can seek redress against the incorrect application of rules, but cannot seek redress against improperly formulated rules or rules that violate superior rules. In a market economy the PRC needs a different kind of regulation from that appropriate for a centrally planned economy with few private actors, a small role for the market, and a dominant government role. This will also require a shift in the perception that legislative drafting and the legal system, generally, are internal government processes that must, in principle, be kept secret. In a market economy regulations can be drafted far more effectively if input from the regulated or any interested parties is considered. A large volume of comments, not all of which will be well thought out and useful, could be problematic, but such problems would not be unique to the PRC, and other administrative legal regimes have found ways to deal with them.

#### **4. Summary**

Awareness of the need for the economy to be governed by predictable rules, properly promulgated, is growing. Moreover, officials are increasingly accepting that their actions need to be justified with reference to defensible laws and regulations; however, this acceptance is not universal. Unlike in industrial market economies, the Government is not treated as an equal actor before the law.

Another area needing improvement to strengthen the rule of law system is the need to develop a reliable and authoritative system for resolving gaps and conflicts in the law. Various ministries and departments issue regulations that may or may not fall within their scope of authority and that may or may not conflict with regulations other bodies have issued, but no entity capable of resolving such problems exists.

Lack of funding is a practical obstacle to reform. Changing the system of local court financing—moving to a system of financing from the center to enhance the courts' independence from local government—requires that the center find the necessary funds within the framework of the budget.

Many desirable reforms confront deeply engrained political and cultural traditions. Greater transparency, for example, would enhance popular supervision of government, but popular supervision of government is sometimes viewed only as a measure for improving government policy rather than as a right.

#### **D. Public Service Delivery and Performance**

An efficient and effective public service delivery system would have the following characteristics. First, it would offer choices to ensure that costs were contained and consumers had variety. Second, the Government would partner with a variety of nongovernment, community, and private sector providers. Finally, to ensure accountability in the delivery of public services, government activities would be transparent. Although a significant amount of competition has been introduced during the last 2 decades and is now the norm for providing industrial and consumer products, competition has not been introduced in the delivery of many public services. The following are some examples where further improvements could be made to improve efficiency and effectiveness in public service delivery:

- Many public services are monopolies, which do not permit citizens to realize the benefits of competition.
- Despite considerable restructuring the Government still provides many services that NGOs could deliver more efficiently.
- Many government agencies still use regulatory power as an instrument to protect and promote departmental or local interests. Such a system creates rent-seeking opportunities for public officials who use their discretionary power to extract payments and other forms of contributions from clients.
- A lack of transparency hinders attempts to hold Government accountable for the delivery of public services.

During the last 20 years public services have undergone dramatic changes, from reallocation of responsibilities among various actors in service provision to reform of the public service delivery system. The main driving forces behind the reform efforts are fiscal stress, high costs, low efficiency, poor service quality, and customer dissatisfaction. Reform of the public service system has been conducted in the context of a radical transition from a centrally planned economy to a market economy. It is therefore quite natural that the PRC's reform has its own specific characteristics.

## **1. Changing Responsibilities for Public Service Provision**

Public services in the PRC may be classified into three major categories: infrastructure construction and operation, including public utilities; human services; and services of a regulatory nature, such as registration and licensing. Positive changes in the responsibility for providing these services have occurred in each category.

### **a. Infrastructure**

The Government's role in infrastructure has been gradually strengthened during the period of reform. Three main factors have contributed to this trend. First, as in many other countries, a key theme of economic and administrative reform has been redefining the Government's role and reallocating responsibilities among different actors in society. Although debates about the Government's proper role in and responsibilities for the economy have been ongoing throughout the reform era, a consensus seems to have emerged in the mid-1980s that infrastructure is an area for which Government bears the main responsibility. In 1999 the central Government formally endorsed the strategy of withdrawing from those areas where it was competing with the private sector. The Government would privatize those areas and focus on infrastructure and key industrial sectors that had a fundamental impact on the national economy. Second, local government officials have increasingly realized that good infrastructure will help attract foreign and domestic investment, and thereby foster economic growth. Third, since 1998 the central Government has adopted a fiscal policy along Keynesian lines to stimulate economic growth, with extra investment of hundreds of billions of yuan each year, mainly in infrastructure.

The vast majority of infrastructure is financed and operated by government agencies; however, the Government's strengthened role in infrastructure does not mean that it bears sole responsibility for construction and operation as it did during the period of central planning. Faced with a shortage of funds and following international trends that include public-private partnerships, the authorities have adopted market approaches or privatization strategies in infrastructure construction and operation that have included lease-build-operate, build-operate-transfer, buy-build-operate, and build-own-operate schemes. Nevertheless, more progress is needed to provide the necessary legal and regulatory frameworks and rules and procedures that will allocate risks fairly to encourage private sector financing of infrastructure. For example, the international investment community has some major concerns about the enforceability of power purchase agreements and of tariff protocols in the power sector.

### **b. Human Services**

In government restructuring, providing human services has undergone a radical change. In the years of the planned economy nearly all human services for state employees were provided by their work unit or employer (government agency, SOE, service unit, or institution). The Government required all work units of a certain size to provide their employees with kindergarten, primary and/or middle schools, shops, hospitals or clinics, and sports and recreation facilities in addition to pensions, security, housing, and other welfare benefits. The system was referred to as agencies (enterprises or service units/institutions) operating as communities. In addition to problems of inequality, such as huge disparities in the levels of services provided by different work units, and widespread shortages in the supply of services, the arrangement deprived enterprises of the opportunity to compete commercially—a key principle of a market economy. To state employees the transition to a new economic system carries with it certain risks, such as the loss of pensions and other welfare benefits if the enterprise goes bankrupt, a phenomenon inconceivable in a centrally planned economy, but quite possible in a market economy. These factors, together with the urgent need to build a human services system compatible with a market economy, made reform in the delivery of human services inevitable.

In view of the huge amounts of funds needed and the fiscal stress facing the various levels of Government, reform has focused on the Government cutting back its management of human services, including key services such as education, social security, health care, and housing. It is doing so through marketization and the sharing of responsibility.

The focus of marketization in education is to attract more resources from society and make individuals bear more responsibility for their own education and that of their children. In primary and secondary education, the authorities have encouraged the development of private schools to supplement the public school system. Public schools also charge fees in the form of donations and fees for choice—those who elect to send their children to a better school than the one assigned by the authorities must pay a fee. Some of the fees violate official rules, but continue to exist in practice partly because of the shortage of funds. Marketization is more obvious in higher education, with the emergence of private colleges and universities. In addition, public institutions that were previously free now charge tuition, which averaged CNY5,000 per student in 2001; higher tuition fees are being charged for adult education and continuing education programs run by public colleges and universities; and campus services such as accommodation are being commercialized.

Marketization in housing has involved terminating the traditional practice of work units allocating housing to employees in accordance with their bureaucratic rank and charging only a token fee. State employees are gradually turning to the housing market and paying market prices, with work units providing them with subsidies based on their rank and on other conditions. This reform is not only helping reduce the overall burden on the Government, but is also helping facilitate sound and rapid development of a housing market.

In social security and health care, the reallocation of responsibilities mainly takes the form of introducing a responsibility sharing system whereby the Government, employers, and employees all contribute. Given the complexity of the arrangement, the Government continues to search for ideal models, proper management systems, and concrete arrangements, often first using a pilot approach to test new policies.

### **c. Regulatory Services**

The rapid expansion of government regulatory activities is a major feature of the economic and administrative reforms. This is a necessary outcome of the separation of Government from SOEs, which has changed the Government's role from one of command and direct control to indirect macroeconomic regulation. Rapid development of the private sector also requires the Government to rely more on regulation to play its role and perform its functions. Problems of unfair competition, protection of intellectual property rights, weak physical property rights, fraud, bootleg products, and other illegal practices in the marketplace make increased government regulation unavoidable for maintaining market order and protecting consumers' interests. Government regulatory activity is not only an exercise of public power, but also provides a type of service that has its own characteristics.

## **2. Improving Public Service Delivery**

During the past 20 years the authorities have made numerous efforts to improve the delivery of public services. Rather than discussing specific methods and measures associated with individual services, the following sections focus on the main mechanisms adopted to improve efficiency, effectiveness, and quality.

### **a. Performance Pledges for Social Services**

The performance pledge system for social services is the PRC's version of the United Kingdom (UK)'s Citizen's Charter, initiated there in the early 1990s, which found its way to the PRC via the performance pledge system in Hong Kong, China. The system was first launched in the city of Yantai in Shandong Province in 1994 by the Municipal Bureau of Construction, and covered some services, such as the bus service and public utilities. The guiding principles and operational measures were much the same as those of the UK's Citizen's Charter. In Yantai the Government carried out the social service performance pledge system with great vigor and successfully raised service efficiency and customer satisfaction. In 1996 eight ministries and commissions of the State Council issued a joint circular promoting the service performance pledge system in key public services nationwide. As the first large-scale campaign to improve public services based on overseas experience with public sector reform, the social service performance pledge system greatly enhanced public officials' awareness of public sector efficiency, effectiveness, and quality and the meaning of customer orientation.

### **b. Effectiveness Building**

In 1999 the Fujian provincial government launched the first province-wide "effectiveness building" campaign in an attempt to improve public services. Like the social service performance pledge system, effectiveness building was a comprehensive approach to improving public services. Based on the experience of Yantai, and incorporating some elements of the social service performance pledge system, authorities in Fujian used a combination of mechanisms and techniques to enhance efficiency, effectiveness, and customer satisfaction. These included the "first encounter responsibility system," which requires that the first civil servant a client encounters should provide sufficient information and help so that the client can readily proceed to the next step. Other improvements included publicizing requirements and work rules,

simplifying procedures, providing “one-stop shop” arrangements, measuring performance, and enhancing public scrutiny.

**c. Reforming the Examination and Approval System in the Regulatory System**

In 1999 the city of Shenzhen initiated reform of the system of examining and approving applications for licenses, which in 2000 the central Government then spread throughout the country via a large-scale campaign that mainly covered regulatory services. Rapid expansion of government regulatory activities has been a major feature of the reform period; however, this expansion of regulation has proceeded in a piecemeal and fragmentary manner, with individual agencies in charge of making rules emphasizing their own needs and perspectives. Some regulatory agencies even use their regulatory power as an instrument to protect and promote departmental or local interests, and many rules violate the spirit of government policy and market principles. While approval by individual agencies may be necessary, and may even be straightforward, the examination and approval system as a whole constitutes a formidable barrier for citizens and the business community. In some cases business projects have required the approval of hundreds of agencies and delays of 6–12 months before projects can get under way.

The system not only makes the environment unfavorable for business by increasing costs and lowering efficiency, but also creates rent-seeking opportunities, whereby public officials can use their discretionary power to extract payments and other forms of “contributions” from clients. The reform of the examination and approval system has proceeded along two basic lines: reducing government intervention and introducing a transparency campaign. The former has taken the form of comprehensive reviews of current rules by special government agencies in an attempt to narrow the scope of examination and eliminate some approval powers currently held by the Government. As a result, the Government has reduced the number of items requiring approval by 30–50%. The transparency campaign has increased the dissemination of rules, application requirements, standards, and examination procedures to ensure fairness and efficiency. The proposed Administrative Licensing Law and Commercial and Industrial Registration Law seek to address these concerns by liberalizing business entry and operation requirements on the one hand, and strengthening necessary supervision and regulation on the other. They are essential parts of a regulatory framework for a market economy.

**d. Rationalizing Administrative Procedures**

While the main focus of reform of the examination and approval system has been to narrow the scope of examination and approval and limit agencies’ power, the focus of procedural reform has been to rationalize and simplify the process for required examination and approval from the customer’s perspective. First, the Government has improved network of informing the general public promptly about rules, requirements, standards, and procedures. Second, the Government has comprehensively reviewed and redesigned the examination and approval process to eliminate duplication, abolish unnecessary steps and requirements imposed on clients, clarify and simplify work flows, set time limits, and so on. Third, the Government has set up one-stop shops, physically concentrating related units so that customers can go through all formalities in a single designated place. One-stop shops have been formed both within a given agency and across groups of agencies. These measures aim to reduce costs and enhance efficiency and customer satisfaction.

#### **e. Service Improvement through Public Participation**

Service improvement through public participation has taken numerous forms. One is the nationwide campaign to place the service sector under public scrutiny. Focusing on individual service sectors, such as the postal service, water and gas supply, and telecommunications, public scrutiny means that the relevant agency regularly invites client representatives and experts to express their views on the quality of services and make comments and suggestions. Some form of reward or punishment may be linked to the investigation to encourage improvement. Another reform focuses on improving the mechanisms for soliciting and dealing with public complaints. Finally, based on international experience, some agencies have carried out customer satisfaction surveys. Some government agencies require such surveys, which are usually conducted by the service provider. In many cases an improvement is required in the form of, for example, a 2% or 3% increase in customer satisfaction over a fixed time frame.

#### **f. Accountability and Transparency**

Accountability requires that public officials are accountable for their behavior and responsive to the entity from which they derive their authority. This may be achieved through various mechanisms, such as sound information and reporting systems, public supervision and oversight, and performance measurement and review. As all public service reforms mentioned have some elements to enhance accountability, the focus here is improving public information and reporting systems, which constitute not only a key part of public accountability, but also a precondition for such accountability. In the PRC accountability through transparency is mainly in the form of open government campaigns. At higher levels of government, open government campaigns focus on improving the provision of public information, while at lower administrative levels they focus on the reporting system. For example, township governments are required to make public their sources and total volume of revenues, expenditure by item, financial and audit reports, and performance review reports if available (see Box 2).

#### **g. Quality Award Schemes**

As in many other countries, authorities in the PRC have adopted quality award schemes to encourage improvements in service quality and customer satisfaction. In the PRC, however, quality award schemes are essentially an internal exercise carried out in a top-down manner. Examinations and reviews of service quality are carried out within government agencies by agency staff, who generally consults neither customers nor the general public. Another major feature of quality award schemes in the PRC is their frequent implementation in the form of campaigns—the agency in charge may select service units and require them to strive for the title “excellent service unit” within a fixed time frame and in accordance with specified standards.

### **3. Addressing Issues in Providing Public Services**

While the PRC has made impressive progress in public service reform, some key issues remain to be addressed.

### **a. Monopoly and Market Entry**

Partly because of the Government's dual role as owner and regulator and partly because of the traditional practices of a centrally planned economy, the Government continues to maintain monopolies in many public services such as utilities and telecommunications. Monopolies are exempt from competition and result in numerous problems commonly encountered in Western countries prior to market-oriented public service reforms. Under constant public pressure, the Government has attempted to break up public monopolies in recent years. In telecommunications, for example, the Government split the giant China Telecom into three companies and allowed other public companies, such as China Unicom and the Railway Telecom Network, to enter the market. This, however, resulted in price wars, which were followed by the Government tightening its regulation and control of prices. Companies also resorted to technical barriers to deter or retaliate against competitors at the expense of consumers.

In the power industry the authorities have sought to separate generation and transmission networks to enhance competition, but in many places the change has resulted in cheaper electricity generated by large-scale hydroelectric power plants with no market, while smaller, less efficient thermal plants are operating at full capacity and more are under construction. This is a typical case of local protectionism that occurred because the central Government owns the hydroelectric power plants while local governments own the thermal power plants.

Greater efforts are therefore needed to open the market and break up various forms of monopoly. This is an objective of the 10<sup>th</sup> Five-Year Plan. Competition will allow market forces to work, improving public service delivery. To this end, research should be conducted focusing on those sectors where market entry is restricted, with the aim of opening the market through policy review and change. Efforts should also be made to search for approaches for opening markets sectorally to avoid the implementation problems described earlier. Moreover, pertinent government regulations should be reviewed and adjusted accordingly as competition increases.

### **b. Market Mechanisms in Providing Public Services**

Apart from breaking up monopolies, which focuses on the issue of market entry, public services can be improved by introducing such market mechanisms as contracting out, market testing, internal markets, franchising, and voucher schemes while maintaining the basic distinction between service providers and producers. In the city of Nanjing in Jiangsu Province, for example, the Government gave a joint venture bus company the franchise to operate several bus lines, while the municipal bus company kept the remaining lines. In a few cities in Shandong Province the Government contracted out street cleaning and solid waste disposal. In both cases costs were reduced and efficiency improved. In general, however, these pilot programs were exceptions rather than general practices. The PRC has borrowed from international practice in its pursuit of public service reform, but a key, and perhaps more effective approach has been largely overlooked—privatization or public-private partnerships.

### **c. Social Justice and Government Responsibility**

As in many other countries, marketization has been a main theme of public service reform. However, what distinguishes the PRC's practice from that of other countries may be its focus on marketization in the delivery of human services. In many countries the objective of introducing market mechanisms of human services is to reduce costs and raise efficiency and quality through competition. In the PRC, however, marketization has become a process of commercialization and, to a large extent, an instrument of government off-loading, particularly at local levels, where government finances have been under stress.

This has created numerous problems. In primary and secondary education, for example, the practice of charging high tuition fees to attend private schools goes against international trends in increasing customer choice, and the rapid increases in tuition fees for higher education are nearly beyond the capacity of ordinary families. In infrastructure, the levels of user fees or toll charges by government agencies or investors under contract or build-own-transfer arrangements are not only excessively high in many cases, but they are also determined arbitrarily, often failing to follow clear standards or to go through bidding procedures, public hearings, or any kind of public deliberation. Facing fiscal stress, many local governments rely on various forms of fees, arbitrary fines, forced investments, and "donations" to raise funds for basic public services (China Enterprise Confederation 2001).

The frequent application of flat rate user charges, which are regressive in nature, harms the poor. While it may be unavoidable for the government of a developing country to turn to commercialization as a partial solution to fiscal stress and to meet huge resource demands during a period of transition, current practice tends to undermine such social values as justice, fairness, equity, and equality. Therefore a critical review of current practices from a normative perspective is necessary.

### **d. Transparency and Public Participation**

Transparency and public participation in the delivery of public services have increased. Future reform should focus on institutionalizing and further improving these areas.

The PRC's efforts to improve transparency have mainly proceeded based on good will rather than on a solid legal foundation. Transparency has yet to be institutionalized. This can be seen in the great disparity between departments and localities in terms of when and how to publicize particular activities, policies, or practices and what to make public. The Government should have a legal framework for institutionalizing transparency with detailed rules. To this end it could consider enacting some sort of freedom of information law as a first step.

Serious measures should be taken to enhance public participation in public service provision. The top-down approach of "public scrutiny of public services" and quality award schemes require a radical change. Public agencies need to supplement information provided by service units on customer satisfaction with more inputs based on real customer surveys. The Government should actively encourage the development of independent intermediate bodies, public service customer groups, and NGOs, which would turn what to date has been an internal exercise into genuine external scrutiny and supervision. Proper procedures and rules should be established and strictly followed in public hearings, to give substance to form. In the long run,

mechanisms for need assessment and impact evaluation should be introduced, turning individual citizens from passive receivers of services into active participants.

#### **4. Summary**

Public service delivery in the PRC is still often characterized by monopoly, which prevents citizens from realizing the benefits of competition. Partnering with NGOs to deliver services is not well developed despite considerable government restructuring. Although the regulatory state has grown in recent years, the Government still often uses its regulatory power to protect or expand departmental or local interests rather than to further develop the market. As a result, rent-seeking opportunities abound. Finally, lack of transparency had hindered attempts to hold Government more accountable for the delivery of public services.

#### **E. Public Accountability**

Accountability here means that public officials are accountable for the Government's behavior and are responsible to the entity from which they derive their authority, such as people's congresses or the CPC. Accountability implies that measurable criteria are available to evaluate the performance of public officials and there are oversight mechanisms to ensure that standards are met. Over time, a lack of accountability tends to undermine the Government's credibility, which can affect its capacity to sustain economic and social development. Although much attention has been paid to this issue in the PRC, further progress is needed in the following areas:

- Even though the authorities have made considerable efforts to hold public officials accountable for results, the system is not yet fully institutionalized or sufficiently transparent.<sup>30</sup>
- While the PRC has made substantial progress in drafting accounting and auditing standards that comply with best international practice, implementing these standards requires further effort.

##### **1. Bureaucratic Accountability**

According to the 1982 Constitution (Article 86), "the Premier assumes overall responsibility for the work of the State Council" and "the Ministers assume overall responsibility for the work of the ministries and commissions." Article 90 reaffirms the ministerial responsibility system using similar language, as does Article 9 of the Organization Law of the State Council (1982), again using similar language. An early test of the ministerial responsibility system came in 1987, when Yang Zhong, the minister of forestry, was removed from office after 193 people died in a huge forest fire that broke out in an area managed by the ministry. This and other cases, such as the removal of the minister of petroleum following the collapse of an oil rig in the Bohai Gulf, established the principle that ministers are responsible for the actions of their ministries and their subordinates; however, this principle has been applied unevenly.

At about the same time a similar system of responsibility, the cadre responsibility system, was established for other administrative personnel. The responsibility system has been extended to all senior officials throughout the country, and recently its consequence has been

<sup>30</sup> A proposed Supervision Law, which aims to define the power of members of the People's Congress at both national and provincial levels in supervising the government and judicial systems, was reviewed in 2002.

widely reported in the media. For example, in May 2001, 21 officials of Shaanxi Province, including the governor, were disciplined for a series of major accidents that occurred in the province in April. In June 2001 the authorities disciplined the party secretary of Shijiazhuang in Hebei Province following a series of explosions that leveled several apartment blocks and killed more than 100 people. Soon after, the CPC replaced the party secretary and mayor of Nanchang in Jiangxi Province following an explosion and fire in a school that killed 13 children. These widely publicized actions were aimed at placating public anger and tightening bureaucratic accountability.

A relatively recent innovation has been local governments' use of performance contracts to improve accountability. Such contracts have become increasingly common in both rural and urban local governments. According to a study (Edin 2001) that examined townships in 14 counties in Jiangsu, Shandong, and Zhejiang provinces, county heads sign performance contracts with subordinate township heads that include explicit soft, hard, and priority targets. Performance evaluation included a variety of methods (top-down, peer review, and bottom-up), and rewards were tied to performance. Hard targets tended to focus on economic indicators, such as tax revenues collected, enterprise profitability, and extent to which investment targets were met. All these targets could be quantified, thereby meeting the good governance criterion of "establishing criteria to measure the performance of public officials" (ADB 1995). Priority targets, also quantifiable, included the extent to which explicit family planning quotas and social order targets were met. The latter could include the extent to which economic crimes of over CNY200 were committed during the reporting year, the extent to which violence resulting in death occurred, the extent to which demonstrations of more than 50 people occurred, the number of letters of complaint received, or the extent of fire damage. Other criteria included the extent to which land was used for burials instead of disposing of bodies by the officially preferred method of cremation or the extent to which air and water pollution exceeded established targets. In each case the criterion could be quantified and a reasonably objective measure of township performance could be produced. Failure to achieve priority targets could override the achievement of economic or hard targets. Bonuses were distributed to township officials based on achieved targets.

Local municipal governments also use performance contracts. In the cities of Changchun and Ningbo, for example, mayors sign performance contracts with the heads of municipal environmental protection bureaus, which specify clean air and water targets. According to the Changchun contract, covering a 1998–2002, environmental protection bureau chiefs were given specific targets, including treating at least 80% of all industrial solid waste, treating all dangerous waste, ensuring the full operation of all pollution treatment facilities, and collecting 100% of all waste discharge fees.

There are, of course, many problems with performance contracts that specify targets in such detail, including which targets are selected, the extent to which targets are measurable and realistic, the extent to which false reporting is likely and/or possible, the extent to which contract implementation is monitored, and the extent to which the contracting party has control over target achievement. Clean air and water, for example, are an outcome of activities by industry, agriculture, the Government, and ordinary citizens, not just a single government agency.

## **2. Accounting, Auditing, and Statistics**

Public sector reforms undertaken since the mid-1980s have also focused on reforming the accounting and auditing systems (Narayan and Reid 2000) by amendments to the 1985

Accounting Law and passage of the 1994 Audit Law. In the early 1990s the authorities decided to develop a series of basic accounting standards that were consistent with international accounting practice and would cater to realities in the PRC. Since 1992 MOF has issued more than 10 such standards, and with one exception there are no significant differences between the PRC's standards and International Accounting Standards.<sup>31</sup> Governments at all administrative levels are required to adopt the standards, which have enhanced bureaucratic accountability. Recent moves by the Government for each agency to set up a single treasury account with the People's Bank of China that is supervised by MOF will also help.

An indication of the increasing professionalism of the accounting field in the PRC was the 1988 decision to set up the Chinese Institute of Certified Public Accountants (CICPA), which is governed by the 1993 Certified Public Accountants Law. CICPA, which has about 135,000 members, is charged with, among other things, managing the registration of certified public accountants (CPAs) and the country's 4,800 publicly and privately owned CPA firms, regulating their practices, and developing and monitoring professional standards. According to the law, CICPA must accept guidance from MOF and the China National Audit Office. CICPA is financed mostly from membership fees paid by CPA firms, which are required to pay 2% of their revenues to the institute. The institute has issued the General Standard on Professional Ethics and the General Standard on Quality Control, both effective in January 1997. CICPA inspects CPA firms to ensure that standards are maintained and MOF is authorized to impose penalties on members for deviating from the professional standards.

MOF and CICPA are committed to improving accounting and auditing practices. Accountants are required to pass a uniform CPA examination and to demonstrate appropriate practical experience to become CICPA members. In 2000, 530,000 candidates took the examination. To improve the quality of CPA firms, the firms undertook a self-assessment from 1997 to 1999 during which 12,700 individual CPAs and 580 CPA firms were forced from the profession for various reasons, mainly for not having the requisite level of knowledge. Warnings and punishments were issued to a further 2,000 firms, or about 43% of the total.

CICPA's current supervisory resources are minimal and inexperienced compared with the number of CPAs and CPA firms and with those in more developed countries. In January 2000, on average, three staff members in each provincial CPA institute were responsible for supervisory activities, and in general their experience and professional knowledge fall short of the necessary requirements for supervisory work. Initiatives to strengthen professional supervision include establishing provincial supervision teams; developing reporting systems in the key finance, securities, and insurance sectors; and introducing, on an experimental basis, peer review systems that are common in industrial market economies. Improved management of the existing examination system is also required to cater to an expected increase in the number of candidates.

Pressure on the PRC to fully implement the standards will increase with the WTO entry, as will pressure to improve the reliability of the PRC's system for collecting and disseminating statistics promptly. During the last several years, national economic accounting estimation in the PRC has made substantial progress, including the implementation of the 1993 Systems of National Accounts. Milestones that have been recently introduced include estimates of GDP by

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<sup>31</sup> The exception requires that in the PRC accountants and relevant authorities agree on divergences from regulations and provisions governing damaged or obsolete inventories (Narayan and Reid 2000, p. 4).

category; production of national accounts by industry; and review and revisions of GDP series. However, it still suffers from serious limitations including those that are due to data coverage and methodological issues. The National Bureau of Statistics is fully aware of these limitations and fully committed to resolving them over time. With the assistance of international development partners, efforts have been made to expand the coverage of the data sources and further refine the methodologies.

### **3. Summary**

Throughout the reform era the Government has emphasized strong bureaucratic accountability, and in recent years has started to use such tools as performance contracting and auditing and accounting systems to achieve international standards; however, work to implement these systems uniformly across all jurisdictions remains to be done. In addition, the Government should now institutionalize the cadre responsibility system.

#### **F. The Public-Private Interface**

The interface between the PRC's well-developed public sector and its emerging private sector has many dimensions, two of which are highlighted here. First, this section looks at the development of the private sector since 1978, its significant contribution to economic development, and the PRC's attempts to create an enabling environment for the sector. Second, it examines recent attempts to improve corporate governance.

Economic development depends on the combined efforts of the Government, NGOs, and the private sector. The Government has recently recognized the private sector's important contributions to sustainable economic growth, but in many respects the bias toward state-owned property and the public sector remains, and the private sector continues to suffer from many problems:

- Laws protecting the private sector, including a law that guarantees equal treatment, are incomplete, outdated, or nonexistent.
- Policy is discontinuous and often uncoordinated and arbitrary, causing confusion among private entrepreneurs.
- Private entrepreneurs are discriminated against in market entry and stronger government regulation of the market is required to ensure order, a condition that benefits all business.
- Financing is often not available to the private sector, which consists largely of small and medium enterprises (SMEs).

Creating modern economic enterprises involves improving the structure of corporate governance. The PRC's accession to the WTO will put pressure on the regulatory authorities to overcome some of the following shortcomings:

- excessive government dominance of the shareholding structure of SOEs that does not allow them to take advantage of the benefits of the shareholding system;
- excessive control of subsidiaries by managers of parent SOEs;

- weaknesses in the capacity of shareholders, boards of directors, and boards of supervisors;
- conflicts between shareholders, boards of directors, and boards of supervisors on the one hand; and party committees, assemblies of workers, and trade unions on the other;
- failure to select managers of SOEs according to market mechanisms and failure to tie their compensation to enterprise performance.

## 1. The Emerging Private Sector

Under the planned economy and the absolute dominance of public ownership, the private sector did not exist prior to the reform era. According to official statistics, in 1978 the PRC had no enterprises under private ownership other than about 140,000 self-employed laborers (All-China Federation of Industry and Commerce and the China Private Economy Research Society 2001, p. 230). During the reform period the private sector has grown rapidly and is now making a substantial contribution to economic development. With the PRC's entry into the WTO and the intensified international competition that will certainly follow, the private sector is facing new challenges and needs to adapt to the new environment. The authorities must also create a level playing field. Sound development management requires creating a favorable environment for private sector development.<sup>32</sup>

### a. Evolution of the Private Sector since 1978

The scope of the private sector constitutes a major barrier to its study. According to official standards set up by the State Council in 1988, all industrial enterprises are classified into six categories—super-scale, large number 1, large number 2, medium number 1, medium number 2, and small—based mainly on their capacity and capital assets directly related to production (Table 8).

**Table 8: Number of SOEs and Nonstate-Owned Enterprises by Size and Gross Industrial Output Value, 2000**

Size	Number of Enterprises	Gross Industrial Output Value (CNY billions)
Super-Scale	336	14,114.28
Large Number 1	2,308	13,987.63
Large Number 2	5,339	10,201.30
Medium Number 1	4,689	4,791.84
Medium Number 2	9,054	5,897.97
Small	141,161	36,380.64

Note: Only enterprises with an annual sales income of more than CNY5 million are included.  
Source: National Bureau of Statistics (2001, p. 401).

<sup>32</sup> For more in-depth assessment of the current environment and proposed ADB program to promote private sector development in the PRC, see ADB Private Sector Assessment, PRC, 2003.

The classification system pertaining to ownership structure is not applicable to the agriculture sector and does not cover the ownership structure of rural industrial enterprises. Thus official statistics do not provide sufficient information for studying the private sector. To complicate the task, in 1998 the National Bureau of Statistics decided to list in its publications only enterprises with a total sales income greater than CNY5 million, and thus data on private enterprises that fall below this threshold are no longer compiled, which means that the majority of them are excluded.

The official classification system identifies three categories of ownership for all nonagricultural economic entities: the state sector, the collective sector, and the private sector. The state sector covers SOEs and state shareholding companies where the Government is the majority shareholder. The collective sector can be further divided into three subcategories: village and township enterprises, which are collectives in their pure form; private enterprises “wearing red hats”? enterprises that are registered as collective enterprises for various reasons but are in reality privately owned; and enterprises under joint ownership with private businesspeople. While the latter two subcategories really fall in the private sector category, official statistics lump them in with collective enterprises. This means that official statistics underestimate the scale of the private sector.

The private sector can be divided into private enterprises (the private economy) and self-employed households (the individual economy) depending on the number of outside laborers employed, a distinction used in official statistics. In 1978 there were about 140,000 self-employed laborers (the number of self-employed households for that year is not available). The number of self-employed households grew rapidly from 1982 to 1983 (126%), 1983 to 1984 (58%), and 1993 to 1994 (24%) and dropped from 1988 to 1989 (14%). Table 9 presents information about self-employed households in recent years.

**Table 9: Self-Employed Households, 1995–1999**

Year	Households		Employees		Investment		Output		Retail Volume	
	Number (‘000)	Growth Rate (%)	Number (‘000)	Growth Rate (%)	Value (CNY billion)	Growth Rate (%)	Value (CNY billion)	Growth Rate (%)	Value (CNY billion)	Growth Rate (%)
1995	25,280	15.6	46,140	22.2	181.3	37.5	279.1	70.4	535.5	27.2
1996	27,040	7.0	50,170	8.7	216.5	19.4	353.9	26.8	670.6	25.2
1997	28,510	5.4	54,420	8.5	257.3	18.8	455.3	28.7	807.4	20.4
1998	31,200	9.5	61,140	12.3	12.0	21.2	596	30.9	978.0	21.1
1999	31,601	1.3	62,409	2.0	3,439.2	10.2	—	—	—	—

Source: All-China Federation of Industry and Commerce and the China Private Economy Research Society (2001, p.230).

During this period the number of private enterprises followed a similar pattern, first rising and then falling. The number of private enterprises grew from 1992 to 1993 (70.4%), from 1993 to 1994 (81.7%), and from 1998 to 1999 (51.4%), but fell in 1989. The total value of registered investment increased from 1992 to 1993 (150.9%), from 1993 to 1994 (170.1%), and from 1994 to 1995 (101.3%). Table 10 presents information about private enterprises in recent years.

**Table 10: Private Enterprises, 1995–1999**

Year	No. of Enterprises		No. of Employees		Investment		Value of Outputs		Retail Volume	
	Number (‘000)	Growth Rate (%)	Number (‘000)	Growth Rate (%)	Value (CNY billion)	Growth Rate (%)	Value (CNY billion)	Growth Rate (%)	Value (CNY billion)	Growth Rate (%)
1995	654.5	51.4	9,560	47.5	262.2	81.1	229.5	101.3	100.6	32.5
1996	819.3	25.2	11,710	22.5	375.2	43.1	322.7	40.6	145.9	45.0
1997	960.7	17.3	13,490	15.2	514.0	37.0	392.3	21.6	185.5	27.1
1998	1,201.0	25.0	17,090	26.7	718.9	40.0	585.3	49.2	305.9	65.0
1999	1,508.9	20.5	20,216	18.3	1,028.7	36.3	—	—	—	—

Source: (All-China Federation of Industry and Commerce and the China Private Economy Research Society 2001, p. 230).

## **b. Role of the Private Sector in Social and Economic Development**

The role of the private sector is better understood by putting it in the context of the PRC’s overall social and economic development, particularly by comparing it with the contribution to economic growth of the SOE sector. The following subsections summarize the major points top government officials have emphasized in official policy and keynote speeches in their recent campaign to promote private sector development.

### **i. Contribution to National Economic Growth**

According to Jng (2001, p. 194), since 1992 the contribution of the nonstate sector to the PRC’s national economic growth has remained at 60% and above. The nonstate sector includes both collective enterprises and the private sector, and the distinction between the two is not clear-cut in practice as mentioned earlier, and tends to underestimate the size of the private sector. The output value of the private sector accounted for only 0.9% of national gross industrial product in 1978, but now constitutes the largest proportion. From the late 1970s to 1997 the number of private enterprises rose from virtually none to 960,000. According to one estimate, by 1998 the PRC had about 2 million private entrepreneurs (Zhou 2000, pp. 99–100).

### **ii. Contribution to Employment**

With the shift of focus from the rural agriculture sector to the urban industrial sector, hidden unemployment has surfaced. In recent years officials have estimated the rate of registered unemployment to be 3.1% among city residents and perhaps higher than 10.0% nationwide when agriculture is taken into account. As most private enterprises are small-scale and labor intensive, the expanding private sector has become an important source of job creation (Table 11).

**Table 11: Number of Employees by Sector, 1995–1999**  
(‘000)

Sector	1995	1996	1997	1998	1999
State (SOEs)	112,610	112,440	110,440	90,580	85,720
Collective	429,370	165,240	462,560	466,500	—
Private					
Private Enterprises	9,560	11,710	13,500	17,100	20,220
Self-Employed	46,140	50,170	54,410	61,140	62,410
Households	55,700	61,880	67,910	78,240	82,630
<b>Private Sector Total</b>	<b>111,400</b>	<b>123,760</b>	<b>135,820</b>	<b>156,480</b>	<b>165,260</b>

Source: National Bureau of Statistics and Ministry of Labor and Social Security (various years); National Bureau of Statistics (2000a, p. 115).

The Government has estimated that from 1978 to 1998, 250 million new jobs were created in the nonagriculture sector nationwide and more than 85 million people found jobs in the private sector, which accounted for 34% of the total. The private sector not only attracted people entering the labor market for the first time, but also absorbed employees of SOEs laid off in the process of structural reform. From 1994 to 1998, for example, the private sector employed 130,000 redundant SOE workers in Shanghai and 240,000 (one third of the total) in Hebei Province (Z. Wang 2001, p. 188).

### iii. Tax Contribution

Taxes contributed by the private sector, while still a small proportion compared with other sectors, have become a source of government revenue. In addition to the industrial and commercial taxes collected from both private enterprises and self-employed households (Table 12), private enterprises pay other taxes, such as turnover tax and corporate tax, plus individual employees pay income taxes. Private businesspeople have also contributed to local governments' nontax revenues in the forms of fees, donations, and payment of fines. Taken together these additional payments equal at least the amount of private businesses' tax contributions.

**Table 12: Private Sector's Contributions of Industrial and Commercial Taxes, 1996–1999**

Category	1996		1997		1998		1999	
	Amount (CNY billion)	Percentage of Total						
Private Enterprises	6.02	1.11	9.05	1.32	16.38	1.90	25.5	2.6
Self-Employed Households	39.70	7.30	46.00	6.70	53.80	6.20	—	—
<b>Total</b>	<b>45.72</b>	<b>8.41</b>	<b>54.05</b>	<b>8.02</b>	<b>70.18</b>	<b>8.10</b>	—	—

Source: All-China Federation of Industry and Commerce and the China Private Economy Research Society (2001, pp. 397–99).

National data may not accurately reflect the importance of the private sector's contribution to government revenue in various provinces. In Jiangsu Province, for example, SOEs only contributed 26% of total financial revenue in 1998, while 74% came from collective enterprises and the private sector (Shen 2001, p. 222). In Hainan Province in 1999, one third of local revenue came from the private sector (Hainan Federation of Commerce 2001, p. 319). If the contributions of red hat private enterprises and of collective enterprises jointly owned with private businesspeople were included, the percentage would be much higher.

#### **iv. Contribution to Market-Oriented Reform**

The essence of the economic reform that began in 1978 is allowing market mechanisms to play an increasing role in allocating factors of production. Market forces are only in full play in SMEs. Without the development of SMEs, the market mechanism would be much weaker.

Top party and government officials stress the significance of the private sector and its role in the PRC's drive to construct a "socialist market economy." After citing the advantages of the private economy, such as having clearly defined property rights, motivating individuals, permitting flexible operations, allowing for easy adaptation to market change, and relieving the Government from having to make high-risk investments, government officials have clarified that "as an important part of the national economy, the private economy serves well the purpose of promoting a socialist market economy" (Tian 1999).

#### **v. Contributions to Reform and Development of SOEs**

The private sector has made substantial contributions to the reform and development of SOEs.<sup>33</sup>

- Tax contributions by the nonstate sector, which account for about two thirds of financial revenue in Guangdong, Hainan, Shandong, Zhejiang, and many other provinces, serve not only to relieve the tax burden on SOEs, but also allow provincial governments to pay for technological upgrades in the SOEs.
- By absorbing a large number of laid-off workers, the rapidly expanding private sector helps improve the environment for SOEs' structural reforms and their drive for efficiency by reducing the number of excess employees.
- The development of the private sector has accumulated a huge amount of social wealth and private capital, thereby enabling banks to provide more loans to SOEs.
- Private entry into the market and capital investment enables the Government to withdraw from competitive areas and focus on infrastructure and selected key industries, thereby facilitating structural reform of the state sector.
- Through purchases or mergers, private businesspeople have saved many small and medium SOEs from bankruptcy in Zhejiang and other provinces.
- Less constrained ideologically, private enterprises are playing a lead role in

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<sup>33</sup> This discussion is based on Shen (2001).

ownership reform and managing innovation, and are providing a role model for SOEs.

- Entry into the market by the private sector helps create a competitive market environment for SOEs, forcing them to change their attitudes, fostering a culture of market competition, and encouraging them to improve their internal management.

#### **vi. Contribution to Political and Social Development**

By creating millions of jobs, the private sector has contributed to political and social stability during a period of transition. The development of the private economy is fostering the emergence of a well-informed middle class that is interested in participating in the formulation of public policy.

The private economy has also facilitated urbanization, a significant contribution to social development. With 65% of the population still living in the countryside, development of the private economy is central to speeding up the process of urbanization. Moreover, the private economy champions equal employment opportunities. A 2000 survey revealed that women accounted for only about one third of employees of government agencies and SOEs, but many more women worked in SMEs under collective and private ownership.

#### **c. Official Policy on the Private Sector**

The socialist planned economy taking shape in the PRC in the 1960s was characterized by the dominance of public ownership, with only a small proportion of the service sector (such as barber shops, small food stores, and repair services) under private ownership. During the Cultural Revolution (1966–1976) these private ventures were attacked as “capitalist tails.” Decades of the planned economy and leftist practices not only eliminated the private sector throughout the country, but also created an ideology that anything “private” was regarded as evil.

During 20 years of reform, official policy toward the private sector has gradually changed from cautious relaxation to active promotion beginning in 1997. This policy change occurred in three phases.

##### **i. Phase 1, 1978–1987: Developing the Individual Economy**

This phase saw a gradual policy shift from passive relaxation to active promotion of the individual economy or self-employed households; however, private enterprise was still restricted and official policy on the development of the private sector remained vague. The Third Plenary Session of the 11<sup>th</sup> CPC Central Committee held at the end of 1978 marked the beginning of reform, including the “open door policy,” and broke down the ideological barriers to the development of the private sector. The practical driving force for reform came from the pressure of unemployed urban residents, of which there were 8 million in 1978. To make the situation worse, millions of educated youths, that is, secondary school graduates from the large cities who had been sent to rural areas during the Cultural Revolution, were returning to the cities with little chance of finding jobs.

The breakthrough came in February 1979, when the State Administration for Industry and Commerce convened a national conference that decided to encourage self-employment and the development of the individual economy, although hiring labor from outside the family was still banned. In 1981 the CPC Central Committee decided to relax this restriction and allowed the employment of “up to two assistants” for self-employed households and up to five “apprentices” for those with highly specialized skills. In 1982 the 12<sup>th</sup> National Congress of the CPC designated the individual economy as “a necessary supplement” to the public sector and decided to promote its development. A few months later the 5<sup>th</sup> NPC passed an amendment to Article 11 of the Constitution that stated that the individual economy is a supplement to the socialist public economy and that the Government should protect its legitimate rights and interests. Since then government policy has promoted the individual economy.

During the 1980s official policy toward private enterprise remained vague. During the early 1980s some households exceeded the 1981 limits on outside laborers, a practice that involved the ideologically charged issue of “exploitation.” To rectify the situation, in 1983 the CPC Central Committee adopted the policy of the “three no's”: no encouragement, no publicity, and no rush to ban.

#### **ii. Phase 2, 1987–1997: Private Economy as a Supplement to the Economy**

In October 1987 the 13<sup>th</sup> National Congress of the CPC officially recognized the term “private economy” and regarded it as “a necessary supplement” to the socialist public economy. Nine months later an amendment to Article 11 of the Constitution was passed in the 7<sup>th</sup> NPC that noted that the state “permits” the existence and development of the private economy and protects its legitimate rights and interests.

As a “necessary supplement” to the socialist public economy, the private economy experienced ups and downs in its development during this phase. Political events in 1989 and the confusion that followed during the campaign against bourgeois liberalization put a brake on its development and resulted in the number of private enterprises falling by 14,000. Deng Xiaoping was only able to change the climate during his 1992 Southern Tour.

#### **iii. Phase 3, 1997–Present: Private Economy as an Important Component of the Economy**

In 1997 the 15<sup>th</sup> National Congress of the CPC upgraded the status of the private economy from “a necessary supplement” to the public sector to “an important component” of the socialist economy. Similar changes were made in the Constitution by means of an amendment to Article 11 adopted by the 9<sup>th</sup> NPC in 1998. Since then the Government has undertaken a large-scale campaign to promote the private sector.

The central Government has promulgated numerous laws and regulations that address such key issues as opening markets, reducing the tax burden, financing, and giving private enterprises the right to engage in international trade. The State Economic and Trade Commission (SETC) has taken concrete measures to promote the development of private sector, and the Law on the Promotion of SMEs, which was passed on 29 June 2002 at the 28<sup>th</sup> meeting of the NPC's Standing Committee. ADB is providing technical assistance to the SETC to develop the operational guidelines and procedures for an SME Promotion Fund effective early 2003.

Yet despite the great progress achieved during the past 20 years, the private sector is still underdeveloped compared with other countries. Moreover, the development of the private sector varies enormously from region to region, implying considerable room for development. Government policy is no longer an obstacle, and recent central government decisions to gradually withdraw SOEs from various competitive sectors provide a good opportunity for expansion of the private economy.

#### d. Factors Impeding Private Sector Development

Both government officials and private businesspeople have pointed to the major factors impeding private sector development. Government officials tend to rank these factors, in order of importance, as the ideological barriers, the legal and policy environment, the market environment, and the shortcomings of the private sector itself (Tian 1999). By contrast, private businesspeople tend to focus on more practical issues. A 2000 survey that asked private businesspeople to rank areas where improvement is needed identified 10 areas in the following order of importance: financial policy, anticorruption policy, tax policy, legal protection of private property, equal treatment of enterprises under different forms of ownership, political system, management of industry and commerce, publicity and propaganda, macroeconomic policy, and the household registration system (Research Group on Private Economy in China 2000). A 2001 ADB-sponsored survey found that problems of the business environment included unfair market competition, local protectionism, monopolies, over-regulation, bootleg products, weak protection of intellectual property, and high taxation.<sup>34</sup> Generally private firms wanted more information about government policies, markets, technology, and financial services? they wanted increased transparency. Surveys have also found that private businesspeople believe that the “hard aspects” of the business environment, like infrastructure and the supply of water, electricity, and raw materials, had improved in recent years,<sup>35</sup> and that efforts now needed to focus on improving the “soft aspects” of the environment, most of which are closely related to sound development management.

#### i. Legal Environment

With the Constitution and basic laws recognizing the private economy as an important component of the socialist economy, legal restrictions based on ideology are no longer a major barrier to the development of the private sector; however, the following aspects of the legal environment still need to be improved.

- **Legal protection of the private sector’s rights.** In recent years reform of the legal system has focused on the operation of a market economy rather than on laws promoting the private sector. The Provisional Regulations on Private Enterprises promulgated in 1988 are outdated. Their protection of private enterprises is too abstract and unbalanced, and focuses too much on private enterprises’ obligations and duties rather than on their rights. Thus in business disputes private enterprises

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<sup>34</sup> The ADB-sponsored survey of 756 private firms in Beijing, Nanhai, Shenyang, Wenzhou, and Xi’an was carried out by the Tsinghua University with the collaboration of the All-China Federation of Chambers of Commerce in September 2001.

<sup>35</sup> The ADB survey found that infrastructure constraints still existed, however, in the five cities surveyed, especially poor roads, inadequate electricity supplies, and inadequate land and buildings.

have difficulties getting effective legal protection. Moreover, government agencies continue to arbitrarily impose fees and fines on the private sector.

- **Legal guarantee of equal treatment for the private sector.** The private sector is discriminated against in market entry, financing, employment, and resource allocation. The recent relaxation has mainly taken the form of policy changes, but many in the private sector remain doubtful of policy continuity when the overall political climate changes. A legal guarantee of equal treatment for the private sector would alleviate this concern.
- **Legal protection of private property.** Private businesspeople have expressed their frustration about the Government's plan to introduce an inheritance tax, while the principle of protecting private property has yet to be enshrined in the Constitution or basic laws. As a result they have sometimes resisted making further investments, preferring instead to move capital abroad and purchase overseas passports as a hedge against the future (Bao 2001, p. 238).

## ii. Policy Environment

In a country where the rule of law is far from established, government policy is crucial to the environment for the private sector. While direction by policy has the advantage of flexibility, it also has the problem of arbitrariness. Taking the policy process as a whole, policy must exhibit more continuity, predictability, consistency, and coordination. In a survey in Guizhou Province, private businesspeople ranked policy discontinuity as the most important risk they faced. An example of this risk was the recent closure throughout Guangxi Autonomous Region of karaoke and disco bars, most of which were licensed and where the business community had invested considerable amounts of money. In another case a private enterprise in Hainan Province had invested CNY70 million in a mine in Guizhou Province, only to find out later that the central Government banned private businesses from running mines. Lack of coordination, policy fragmentation, and departmentalization continue to affect policy on the private sector. When government agencies take on the dual roles of owner and policymaker or regulator, their natural tendency is to protect their own enterprises rather than to create a favorable environment for the private sector.

## iii. Market Environment

Despite improvements in recent years the private sector is still operating under a less-than-optimal market environment. Greater efforts are needed to ensure open markets and fair competition between various sectors.

- **Market entry.** Discrimination prohibiting the private sector from entering some markets has taken several forms. Private businesspeople cannot understand why they are banned from entering the finance, oil, and automobile sectors while foreign companies can do so. State-owned and private enterprises also face different standards when applying for listing on the stock market. In addition, local governments frequently resort to administrative monopolies to protect their interests. The privatization process for small and medium SOEs includes special restrictions for private sector buyers, contractors, or franchise holders. In the allocation of land and other productive factors, the private sector cannot compete with publicly owned enterprises on an equal footing.

- **Market order.** During the transition to a market economy a unified and fully competitive market is still a goal rather than a reality. Like other actors, private enterprises operate in a market still in various forms of disorder. In this respect, however, private businesses are the culprits as well as the victims. Nevertheless, healthy and sustainable development of the private sector requires substantial improvement in market order.
- **Tax and nontax financial burdens.** Private businesses rank tax and nonfinancial burdens as one of the main obstacles to further development of the private sector. By international standards the tax level for private enterprises in the PRC is low, but the nontax financial burden is large. In 1998 the nontax financial burden in the forms of fees, arbitrary fines, forced investments, and forced donations was nearly twice the amount of taxes paid. The China Entrepreneur Confederation has raised this issue with the Government. Corruption among public officials greatly increases the costs of doing business, particularly for private enterprises.

#### iv. Financing

Although discriminatory financing is no longer public policy, in practice private businesses have had problems obtaining access to financing. Indeed, this issue still ranks as the number one issue for most private businesses. The 2001 ADB-sponsored survey of private firms found that firms encountered difficulties in obtaining credit because they were small, were not state owned, could not provide credit guarantees, and often lacked a credit history or good connections. Policy restrictions were also perceived to be an impediment in this regard. The following factors contribute to the situation:

- Societal capital is weak and the capital market, especially private financial institutions, is underdeveloped leaving the state banking system as the dominant supplier of capital; however, state banks are not yet sufficiently market oriented.<sup>36</sup>
- State banks lack the capacity to inject large amounts of capital into SOEs to help them out of difficulties and at the same time provide substantial support for the private sector.
- Despite the removal of policy discrimination against the private sector in financing, which has occurred during the commercialization of the state banking system, state banks are reluctant to grant loans to the private sector because of the high risk and high management costs. Most private enterprises are small-scale and their assets are not of high quality. More important is the problem of creditworthiness of private businesspeople, which increases banks' risk and makes subsequent loans more difficult.

#### v. Private Sector Shortcomings

The private sector's own shortcomings also constitute a formidable barrier to its healthy development. First, most private enterprises are small-scale and engage in labor-intensive, low-technology industry. Second, most private enterprises are owned by a family or a single

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<sup>36</sup> State banks are constrained by their high levels of nonperforming loans (NPLs). Since 1999, the PRC has set up four asset management companies and purchased NPLs totaling CNY1.39 trillion, lowering the rate of NPLs to loans granted by state-owned banks by 9.7% while substantially improving their overall asset quality. However, the tide of NPLs is yet to be stemmed, since the NPL ratio is higher in the PRC than in many Asian countries.

businessperson. When the enterprise's capital and assets reach a certain size, the ownership structure becomes an obstacle to further growth. In addition, nearly all key management positions are occupied by family members or relatives, which not only means that the company may not be using the best available managers, but undermines employees' motivation. Moreover, the management systems of many private enterprises are characterized by excessive centralization and arbitrary decision making by the owner, adding risks in an increasingly competitive market environment. Finally, many private businesspeople have adopted short-sighted business and marketing strategies? many resort to illegal or immoral practices to make a profit, thereby harming consumers, competitors, and suppliers of capital and materials. The outcome is unfair competition, market disorder, and widespread doubt about the credibility of the private sector, which in the long run harms the entire sector.

#### **e. Trends in Reform**

In the context of the 1999 official campaign to promote the private sector, government agencies and NGOs have been making serious efforts to improve the environment for private sector development.

##### **i. Legal System Reform**

The Government has initiated legal reform to support the private sector. Mostly initiated by the Bureau for SMEs under the State Economic and Trade Commission, a Law on the Promotion of SMEs, was passed on 29 June 2002 at the 28<sup>th</sup> meeting of the NPC's Standing Committee. Among other things this law provides for SME guarantee funds to improve access to credit. An important part of the work is a search for a new classification system for all kinds of enterprises. As private enterprises constitute a majority of SMEs, laws aimed at promoting SMEs and related activities should be supported.

High on the agenda should be laws relating to market operations, such as antimonopoly provisions. Such laws will help rectify the current market disorder and improve the market environment for sustainable development of the private sector. Legal reform to better control government action is also necessary. As corruption and rent-seeking among public officials are a major obstacle to private sector development, efforts to restrict government intervention or regulate its behavior should be supported. Current efforts to reform the public finance system and the examination and approval system should also be encouraged. Finally, efforts to enshrine the principle of protection of private property in the Constitution or basic laws and to strengthen the legal guarantees of equal treatment for the private sector should be encouraged.

##### **ii. Policy Reform**

The impact of government policy is clear, for example, even though legal provisions remained unchanged from 1989 to 1992? when the policy atmosphere changed during these years the private sector contracted and then expanded. Thus first, further reforms are necessary to market entry in certain industries, public finance, taxation, labor market management, and the household registration system. Rules for exit should also be clarified and an effective bankruptcy law adopted.

Second, serious efforts should be made to reduce the risks of departmentalization in policy making. Most important is ensuring that policy making bodies are independent, and

industries must overcome their excessive dependence on government agencies to initiate and make policies.

Third, to reduce policy fragmentation and departmentalization in policy making and to ensure consistency among policies, coordination in policy making should be strengthened. This could be achieved either by enhancing the role and capacity of macroeconomic management bodies such as the SDPC in policy coordination, or by creating a central policy review unit under the State Council.

Fourth, beyond individual policy areas where an established agency is in charge, the Government should approach policy issues strategically in an attempt to ensure continuity, predictability, and consistency. The Development Research Center of the State Council or other independent research institutions could perform this task.

Fifth, policy making is less transparent than lawmaking and reform of the policy making process to enhance open deliberation and public participation should be encouraged.

Finally, law enforcement and policy implementation have long been weak links in the PRC. The Legal Affairs Office of the State Council is now considering the introduction of a law enforcement responsibility system.

### **iii. Financing**

The Bureau of SMEs of the State Economic and Trade Commission has made major efforts to solve problems pertaining to SME financing. These efforts currently focus on developing a credit guarantee system to enable SMEs to obtain loans from the established financial market. The credit guarantee network being established consists of three layers of institutions at the central, provincial, and municipal (prefecture) levels. In addition to the more than 200 credit guarantee institutions sponsored by governments at these levels, about 300 mutual help institutions and many commercial credit guarantee institutions provide credit guarantee services. Of the 300 mutual help institutions 104 have been incorporated into a network and the Government has granted them tax-exempt status to promote their development. The next step is to establish a state mechanism for providing reguarantee services to the credit guarantee institutions to better manage risk. For this purpose 10 ministries and commissions jointly issued an official document on SME credit management in April 2001.

In recent years ADB and other development partners, for example, Germany, Japan, United Kingdom, the World Bank, and UNDP, have sponsored research projects and pilot programs to search for solutions to the financing problems facing SMEs. Most of the programs have a narrow focus and are intended for a given geographical area. What is needed now is to approach the issue from a broader perspective with the aim of providing lessons and experiences that can be replicated in other areas. The PRC should also remain receptive to and draw lessons from the experiences of other countries.

### **iv. Government as a Service Provider**

Under decades of a command economy the Government played multiple roles as owner, resource distributor, director, and controller in its relations with SOEs, but focused less attention on providing public services. To create a favorable environment for private sector development, the Government must redefine its role from controller to service provider. The private sector

currently requires the following government services, and efforts to provide them should be supported.

First, some enterprises have suffered losses in cross-border trade because of their lack of information about the basic rules of international trade, quality standards, and the market situation in other countries. While large SOEs have made some progress in this area, this still remains a formidable barrier for private enterprises because of their small scale and the costs involved. Following the practice of industrial countries, a specific government agency should provide information and training to facilitate exports by private enterprises.

Second, the Government should provide information services to private enterprises about conditions in the domestic market. It should provide such services continuously through a reliable channel that is easily accessible and inexpensive. The Government collects a huge amount of data that to date the private sector has underutilized. A first step would be to make these data more open to the public in accordance with a suitable classification system. Government services could also take the form of providing support and direction to help private enterprises reform their ownership structure, improve their management, upgrade their technology, and enhance their product quality.

#### **v. Role of NGOs**

A large number of NGOs have played an active role in promoting private sector development, for example, the All-China Federation of Industry and Commerce and the China Private Economy Research Society. Since 1998, when the NBS decided to list only enterprises of a certain scale in its publications, these NGOs have attempted to collect basic data and information on the private sector that they publish in the annual China Private Economy Yearbook. Since 1993 the China Private Economy Research Society has conducted four large-scale, nationwide, empirical surveys on the development of the private economy and published reports, such as the *Development Report of Private Economy in China: 1978–98*. Several small-scale surveys have also been conducted to identify the main problems and needs of private businesspeople. On the basis of this kind of information, the NGOs make recommendations and request laws and policy adjustments through various channels, like the CPC's Central Committee and NPC on behalf of the private sector. In addition, these NGOs have provided various kinds of training and information services to private enterprises in an attempt to encourage management innovation.

In view of the fiscal stress facing those organizations, ways of raising revenues and providing financial support need to be found to enable them to continue their work in collecting and compiling data and information on the private sector and surveying the private economy.

## **2. Corporate Governance**

Enterprises in the PRC have only recently come to understand the importance of sound corporate governance for the development of state-owned and other enterprises. In its narrow sense corporate governance concerns the institutional arrangements governing the internal relationships between boards of directors, boards of supervisors, and senior management groups in terms of their respective rights and duties. In a broad sense corporate governance also covers the relationships between the corporation and outside actors, such as the government, customers, suppliers, and other stakeholders. In the PRC efforts to improve corporate governance have focused mainly on internal relationships within corporations.

### **a. Corporate Governance before 1993**

Reform in the 1980s emphasized adjusting the relationships between SOEs and the government agencies in charge, and the concept of corporate governance was not considered. The reform of SOEs prior to 1993 can be divided into three stages (He 1999, pp. 74–80).

#### **i. Before 1978**

Prior to the period of opening up and reform, nearly all enterprises were state-owned, with government agencies exercising the ultimate power of control on behalf of the general public (the nominal owners). Operations and daily management were delegated to senior management groups appointed by the government agency in charge, leading to a special principal-agent relationship. With the problems of information asymmetry and incentive compatibility associated with all principal-agent arrangements, the government agency had to rely on direct control to ensure accountability. Thus under this system corporate governance in SOEs had two major characteristics. First, enterprises became appendages of the Government, with all profits handed over to the Government or, in the case of losses, with the Government providing subsidies. Second, managers had no autonomy in managing the enterprises as the Government made all major decisions, including decisions about investment, production, pricing, marketing, and personnel management.

#### **ii. Early Years of Reform**

From 1978 to 1987 SOE management was decentralized and the Government introduced a profit-sharing scheme. Managers of SOEs were allowed to decide what and how many products to produce in accordance with the market situation and their relative strength, on the precondition that they met the Government's production quotas. To provide incentives to managers, the Government introduced a profit-sharing scheme that took various forms. In 1979 a pilot scheme allowed some SOEs to keep a fixed percentage of all their profits. In 1980 this was changed into a system that allowed enterprises to keep a smaller proportion of profits below a baseline and a much larger proportion of profits above the baseline. Beginning in 1981 enterprises could keep all profits after turning over a sum fixed in advance. In 1983 the profit-sharing scheme was replaced by a corporate income tax.

Decentralization implied a flow of power from the Government to enterprises, and the aim was to turn SOEs from an appendage of the Government into independent entities. Along with more forms of profit sharing, the reform efforts during this period made some progress in enhancing management autonomy and improving motivation; however, government agencies in their capacity as owner remained in a dominant position in relation to decision making, and management autonomy was far from sufficient. Moreover, given the blurred boundary between the rights and duties of the parties involved, information asymmetry, government failure in supervision, and opportunist behavior on the part of managers, the reforms produced some undesirable results, mainly in the form of illegal flows of state assets into private hands.

#### **iii. Contract Management**

Decentralization and the introduction of profit-sharing schemes may be seen as the first step in a continuous effort to corporatize the SOEs. Another important measure was a sort of privatization? contract management. Under the management responsibility system, SOE managers had to ensure the payment of a fixed amount to the Government and were then

allowed to keep the surplus. The managers were responsible for any losses. As contract management meant more management autonomy and improved motivation, it became more popular than corporatizing the SOEs, and until the end of 1989, most SOEs were under contract management. A key problem associated with contract management was that the relationship between government agencies (principals) and managers (agents) was administrative? contractors were selected by the government agency in charge and most were former employees of the SOE, with little competition in the contracting process. In addition, short-term contracts encouraged short-term behavior. In many cases, managers ended up being responsible for surpluses only and the Government had to bear the burden of losses.

### **b. Problems of Corporate Governance since 1993**

The concept of corporate governance was not raised until 1993 when the Third Plenary Session of the 14<sup>th</sup> Congress of the CPC issued a document on the construction of the socialist market economy. The transformation of SOEs' operating mechanisms was put high on the agenda in an attempt to establish a "modern corporate system" for SOEs. In December 1993 the NPC's Standing Committee enacted the Company Law. Following some pilot projects, the Government launched a campaign to transform the governance of SOEs, focusing on setting up boards of directors, boards of supervisors, and senior management groups within each SOE. The Government emphasized the independence of these different groups and of check-and-balance mechanisms to ensure coordinated functioning and effective management. To achieve this, the ownership structure was reformed at the same time.

Despite progress since 1993, problems still exist because of the policy environment, institutional constraints, and a lack of experience with corporate governance issues (He 1999, pp. 80–92).

### **c. Ownership Structure**

The ownership structure has been a problem for SOEs for many years (Tenev and Zhang 2002). After years of divestment, the Government dominance of joint holding companies has changed little. A sample survey found that the Government was the biggest shareholder in 53.6% of joint holding companies and held more than 50% of the total shares in half of such companies (He 1998). This leaves the Government having the final say in most major decisions. Excessive concentration of shares has also allowed dominant shareholders to manipulate the composition of boards of directors, boards of supervisors, and managers at the expense of small investors' rights and interests. Moreover, this situation contradicts the principle of separation between the Government and enterprises endorsed since the start of SOE reform.

#### **i. Control by Insiders**

Control by insiders refers to the continuing dominance of managers of SOEs converted into joint stockholding companies. A 2000 survey revealed that the boards of directors of listed companies averaged 9.7 members, and that 6.5 of them were drawn from the original SOE. In 83 of the companies surveyed (20.4% of the total) insiders occupied all the directorships. In about a third of the companies surveyed insiders accounted for 70–99% of boards of directors, and only occupied 30% or fewer positions in less than a tenth of the companies. Control by

insiders has resulted in such problems as short-term behavior, illegal dealings, tax evasion, and wage and benefit maximization at the expense of other investors.

## **ii. Functioning of the “New Three”**

The “new three” refers to the three components of corporate governance: the shareholders, the board of directors, and the board of supervisors. Although widely established in the process of SOE reform, the three bodies have encountered numerous problems. In some cases the new structures became formalities without substance. No rules mandate shareholders’ meetings, and in many companies they have never been convened. Moreover, when they have been convened, those participating have tended to be government representatives and corporate shareholders, who have overwhelmed small, individual shareholders. In addition, assemblies of shareholders tend to have limited power and cannot perform their duties adequately.

The composition of boards of directors has been problematic. Some companies set board membership at an even number, leaving room for stalemates and indecision. Lack of transparency has also hampered the operations of boards of directors. Many board members, particularly chairs, are either appointed or nominated by government agencies, leading to ambiguity with regard to the power and authority of boards of directors, and in some cases board chairs do not know what authority they possess and how to exercise it. As a result, boards of directors have sometimes been unable to exercise their oversight powers effectively and abuses have occurred. According to an official audit of the 2000 accounts of the country’s 1,290 largest SOEs, more than two thirds had falsified their accounts by an amount exceeding CNY100 billion (South China Morning Post 25 November 2001). Effective boards of directors should help curb such abuses.

Problems with boards of supervisors include the Government’s dominance of the appointment of board members, the dominance of board membership by insiders, the lack of special expertise required of supervisors, and the supervisors’ failure to perform their designated duties.

## **iii. Friction Between the Traditional Power Structure and the New Three**

Traditionally each SOE has a CPC committee, an assembly of employees, and a trade union. Under the previous system of unified leadership of the party committee, managers were accountable to the party committee, while the assembly of employees and the trade union were responsible for supervision. With the establishment of the new three the relationship between the traditional power structure and the new three has become a delicate and difficult one. In theory the new three should have replaced the traditional power structure. In practice, however, the traditional institutions are still operating. As a result, friction and conflict between them are likely to exist for some time to come.

## **d. Reform Trends**

Given the problems summarized above and the challenges posed by the PRC’s entry into the WTO, greater efforts have to be made to improve corporate governance (China Enterprise Management Association 2001, pp. 690–91). Such efforts should focus on the following:

- **Reforming the ownership structure.** In 2000 the Fourth Plenary Session of the 15<sup>th</sup> Central Committee of the CPC adopted a decision for strategic restructuring of the SOEs in an attempt to make their internal corporate governance more appropriate for a market system. The key restructuring measure is ownership reform, which has taken various forms, such as reducing state shareholdings; selling government assets; giving open access to private investment; and introducing measures to attract capital investment from nongovernment sources, including overseas investors. Widely dispersed share ownership helps create well-balanced relationships among key investors and lays a foundation for improved corporate governance.<sup>37</sup>
- **Separating the Government from enterprises.** Although the principle of separation between the Government and enterprises was endorsed at the start of reform, excessive control and arbitrary intervention by government agencies in charge is still a problem that many SOEs face. Consequently, the goal of turning SOEs into independent entities with adequate autonomy while at the same time making them responsible for all their profits and losses still remains a goal to be achieved in the future in many cases. Efforts to redefine the Government's role and restructure its functions should be intensified, and institutional arrangements should be improved to rationalize the relationship between principal (Government as investor) and agent (legal person of an enterprise). Closely related to this, the current practice of assigning administrative rank equivalents to managers should be phased out.
- **Expanding the role of the new three.** Despite some progress in establishing assemblies of shareholders, boards of directors, and boards of supervisors in most large SOEs and government holding companies, more efforts must be made to ensure their proper functioning. The structural overlap between party committees, employee assemblies, and trade unions on the one hand; and shareholders, boards of directors, and boards of supervisors on the other, should be addressed and their respective rights and duties clarified with a long-term aim of empowering the latter. As for the functioning of the new three, the problems mentioned earlier should be resolved to ensure that each group performs its duties appropriately. Arbitrary intervention by government agencies should also be dealt with.
- **Improving the system for remunerating managers.** Greater efforts should be made to improve and institutionalize motivation and constraint mechanisms for senior managers. Remuneration for managers should be sufficient to motivate them, and their remuneration packages should be clearly tied to their enterprises' performance. To this end a variety of mechanisms could be used, including stock options. Moreover, the incentives of managers of SOEs (and of local governments) should be more closely aligned with national interests (Tenev and Zhang 2002).

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<sup>37</sup> The province of Shenzhen, considered a pioneer in SOE reform, is planning to sell between 25% and 45% of company shares in four major SOEs through international tender, including Shenzhen Energy, Water, Gas and Public Transportation.

## **G. The Role of Civil Society**

Sound development management for sustainable economic and social growth requires the Government to partner with civil society to produce goods and services that meet people's needs. As the Government has shed responsibilities during the process of administrative restructuring for a market economy, especially in relation to social services, the authorities have come to rely on a particular kind of NGO largely unique to the PRC to fill the gap. These NGOs are characterized by a close relationship with the Government (indeed, the Government has actively encouraged establishing most of them), but a relationship that in practice has varied considerably (Saich 2000). Some organizations are relatively autonomous in relation to the Government. Generally NGOs perform less of a policy advocacy role and more of a social service and support role. To a large extent they rely on their own resources for funding.

To effectively perform their roles, however, NGOs, and civil society in general, need access to information through such channels as the media. Indeed, access to information is intimately related to economic development. Without access to information entrepreneurs cannot make informed investment and marketing decisions, which leads to inefficiencies. Although unprecedented numbers of citizens now have access to the media and the Internet, government control in these two areas is still tight.

### **1. Nongovernment Organizations**

During the 1980s the PRC had more than 220,000 NGOs (also referred to as social organizations) (Wang and Hu 2001). As a result of having to reregister in the 1990s the number of NGOs of all types that registered with the civil affairs departments of local governments at and above the county level had fallen to 136,000 by October 2000. NGOs include a range of organizations, for instance, the Yunnan Reproductive Health Association, Rural Women Knowing All (which organizes training and does publications for rural women), and the Center for Biodiversity and Indigenous Knowledge. Foundations have set up such institutions as the Network of Foundations and Nonprofit Organizations, which raise funds for members' foundations, provide training, and organize and publicize research projects.<sup>38</sup>

A 2000 survey of the activities of NGOs in Beijing (M. Wang 2001) indicated that most of them are involved in research (Table 13). The same survey also indicated that many provide services and carry out publicity, training, and international exchanges, and that 38.5% provide policy recommendations to the Government. According to the survey, 68.7% of NGOs operate in a single city, district, or county. More than 90% reported that they had a constitutional document of some kind. Members of the surveyed NGOs came from among upper-middle school graduates (31.7%) and graduates of junior colleges (27.4%) and universities (29.8%). The surveyed NGOs reported that half of their budget came from government subsidies (50%) and about 21.0% from member fees. Only about 5.6% came from business activities and less than 2.0% came from overseas donations. The NGOs spent about 34.0% of their budgets on personnel costs and 45.5% on newsletters, publicity, and advisory services. About half reported that they produced an annual financial report that was internally audited, while only 14.7% had their accounts audited externally. Contact with overseas NGOs was limited: more than 70% of the NGOs reported that they had no contact with any overseas NGO.

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<sup>38</sup> For a list of NGOs active in the PRC see China Development Brief (2001).

**Table 13: NGO Activities, Beijing, 2000**

Activity	Percentage of Time Spent on the Activity
Investigation, Research	63.7
Professional Association, Guild, Academy	50.0
Social Services	22.1
International Exchanges	22.1
Policy Consultation	20.2
Poverty Alleviation, Flood Prevention, Other Disasters	18.3
Environmental Protection, Animal Protection	16.3
Professional, Adult Education	13.5
Sports, Health, Recreation	11.5
Law Consultation and Services	11.5
Other	10.5
Community Development	9.6
Foundation	9.6
Culture, The Arts	8.7
Voluntary Association	8.7
Home for the Aged	5.8
International Aid	4.8
Psychological Consultation	3.9
Employment and Re-Employment	3.9
Hospital, Recovery Center	1.9
Clubs	1.0
Private Schools	1.0

Source: Wang (2001, p. 210).

#### **a. Regulatory Framework**

The regulatory framework for NGOs dates from 1989, when the Regulations on the Registration and Administration of Social Organizations were adopted. The Government has since promulgated Management Measures on Foundations (1988) and the Interim Procedures for Foreign Chambers of Commerce (1989). In 1998 the authorities issued the Interim Procedures on the Registration and Administration of Private Nonprofit Organizations and revised the regulations for NGOs. A year later the Government passed the Law on Donations for Public Welfare. Further reforms of the legal and regulatory system are expected as the PRC fine-tunes the management process.

According to the 1998 regulations NGOs are defined as nonprofit civil organizations, made up of citizens who have joined voluntarily, and engage in the activities set down in their charters. They include several types of trade unions, associations, chambers of commerce, foundations, societies that promote various causes, societies that carry out or sponsor research on particular topics, and friendship associations, many of which are funded by the Government or managed by government officials in a top-down fashion. Other organizations lack official connections and have been established by people interested in social welfare issues. These may be referred to as bottom-up NGOs.

Another type of civil organization is the publicly run nonentrepreneurial units, which mainly consist of social service organizations such as schools, hospitals, welfare institutions (old people's homes, pensioners' apartments), community service centers, professional training centers, research institutes, cultural centers, and sports facilities. These organizations

mushroomed, mostly in the 1990s, as result of the development of the market economy. Accurate statistics on the number of such civil organizations, which have registered with various government agencies, are not available but they are estimated to number over 700,000 (M. Wang 2001). According to the laws and regulations promulgated by the State Council in 1998, publicly run nonentrepreneurial units are defined as civil organizations engaging in nonprofit social services that have been established with nonstate assets by enterprises, government organizations, other social entities, and individual citizens. Legally they fall into the category of NGOs.

The PRC also has many unregistered civil organizations that engage in social welfare activities as well as civil organizations that have registered as businesses and enterprises, but are actually devoted to nonprofit activities. Usually these two types of organizations are fairly small and have only limited influence, but as they expand and become more influential, they tend to want formal, legal status. Conditions permitting, they will invariably seek ways to transform into NGOs or publicly run, nonentrepreneurial units.

Current regulations impose some restrictions on the operation of NGOs. According to the regulations, civil affairs departments are responsible for registering NGOs and maintaining records on their founding, changes in status, or closure. They must also conduct annual inspections and take disciplinary action against organizations found to be violating the law. NGOs must find a government sponsor to supervise their activities. The laws and regulations also require that the range of activities an NGO engages in does not exceed the scope of its administrative jurisdiction and that no other similar NGO can operate in the same administrative region, although NGOs are, in principle, now allowed to set up branch organizations in lower administrative regions. Such rules keep NGOs geographically separated and isolated, and also prevent competition and comparison amongst them, thereby artificially establishing and maintaining monopolies by some civil organizations.

Under such circumstances, NGOs are unlikely to become large, national organizations with wide influence and strong organizational and coordination capacities unless they are set up by the Government and depend on government administrative networks for their operation. Examples of government-established NGOs include the Chinese Society of Family Planning and the China Society of Youth Volunteers, both of which have huge networks of branch agencies. Although they are NGOs according to the law, their administrative systems remain governmental and their beneficiaries appropriately view them as arms of the Government.

#### **b. Relationships with the Government, Sponsors, and Beneficiaries**

Top-down NGOs are set up with government support that receive various kinds of direct or indirect special funding and assistance and are managed and controlled by the Government. While they enjoy special help from the Government, they are also subject to government control. Their main resources, including funding, human resources, and information are acquired through government channels; their officials are appointed through the government system; and the Government provides staff compensation and benefits. These sorts of organizations dominate NGOs in the PRC. In the Beijing survey of NGOs almost half reported that their leading personnel came from government agencies. Another 28% came from service units or institutions and only 8% came from “people’s organizations.”

Bottom-up NGOs are independently set up by people with an interest in social welfare issues. They are usually ineligible for preferential treatment by the Government, but are also

subject to less government control. They maintain ties with ordinary citizens through their grassroots organizations, and their main resources, such as funding, information, and volunteers, come from bottom-up channels, partly from ordinary citizens and partly from funding organizations, including international NGOs.

NGOs initially entered the field of public policy because of concern about limiting population growth. The PRC's large and growing population had hindered economic development. In tackling the population problem, the Government realized that its capacity to deal with the issue was limited. It urged concerned citizens to operate outside the Government and to solicit funds from international sources.

The sustainability of economic development is being threatened by grave environmental and natural resource conservation problems. In the search for solutions the PRC has relied on civil forces and public participation. At the same time, some environmentally-conscious people have organized and devoted themselves to preserving and protecting natural resources and curbing environmental pollution. Many new environmental NGOs have appeared. NGOs have also tackled other problems, such as poverty reduction, school dropouts, welfare for the disabled, the elderly, women, health, social aid, and community development.

Because of the unique circumstances described earlier NGOs have gained the understanding and support of both the Government and society. While the Government has sometimes imposed restrictions on NGOs operating in certain areas, it has also sponsored some semi official, semi civil agencies to solve pressing social problems. Generally speaking, whether top-down or bottom-up, NGOs work relatively closely with the Government. This phenomenon sets them apart from NGOs in Japan, Republic of Korea, and Philippines, where well-established NGOs have developed tense, adversarial relationships with the Government. Of course, some conflicts of interest do occur in the PRC, but they have generally been solved through negotiation. However, healthy cooperative relations between NGOs and the Government are usually confined to areas that the Government sees as appropriate for their participation.

Most funding for NGOs comes from business ventures, membership fees, donations from the public, and grants and donations from overseas sponsors. Many NGOs are beginning to attach importance to establishing relationships with overseas sponsors. To attract funding they have sought to improve their public image by publishing annual financial reports and organizing seminars, presentations, exhibitions, and so forth. Some NGOs not only cooperate with sponsors on a project basis and establish effective systems for formulating and running projects to the standards set by sponsors, but they are also starting to emphasize their own organizational capacity building with a view to long-term, sustained development of their organizations.

NGOs that are active in the areas of poverty relief, environmental protection, legal aid, and community development have usually built up channels for communicating with their beneficiaries. Many NGOs have adopted one-to-one aid and exchange models, which increase transparency and accountability. NGOs have emphasized participatory styles of poverty relief in rural communities, and have achieved encouraging results.

In relation to individual charitable work, voluntary service initiatives are becoming more formalized. The process of drafting laws and national regulations pertaining to individual volunteerism and volunteers' rights is also gaining momentum.

### c. Organization

Most top-down NGOs enjoy appropriate administrative level treatment in accordance with the administrative rank of their supervising government agency, including government status, salaries, and compensation; free or cheap housing; professional and technical titles; social security; and the right to issue overseas visit permits. In fiscal administration NGOs and publicly run, nonentrepreneurial units both resemble government organizations.

Bottom-up NGOs seldom resemble government agencies organizationally and enjoy neither government status nor preferential treatment, and tend to be more participative. However, they suffer from such problems as weak financial management, which constrains their development. Many NGOs are starting to emphasize training and capacity building and attempting to improve the management capacity of their leaders and administrators.

As overseas NGOs enter the PRC they have brought with them not only funding and projects, but also management models unique to NGOs. Many overseas NGOs now cooperate with their local counterparts. Generally speaking, civil affairs departments at various levels of governments have taken an active and open attitude toward the economic and social development activities of overseas NGOs. Despite the lack of laws and regulations covering their operations, in 2001 overseas NGOs appeared to enjoy relatively relaxed treatment by the authorities. Indeed, in October 2001 the Government announced that foreign NGOs would be encouraged to operate in the PRC and to participate in critical social welfare areas such as poverty reduction (State Council 2001).

In October 2001 the first International Conference on NGO Poverty Reduction Policy, hosted by the China Foundation for Poverty Alleviation, was convened in Beijing. It brought together more than 200 representatives of local and international NGOs, bilateral and multilateral financial institutions, universities, and government institutions. The conference concluded that 20–35% of the substantive work in poverty reduction in the PRC between 1995 and 2000 could be attributed to NGOs. However, several factors limit the work of NGOs, including a lack of funding, inadequate training, an incomplete legal framework, the difficulties of registering international NGOs, and the problems in recruiting and retaining qualified staff.

The Government's effort to mobilize NGOs to address social concerns was assisted by the passage of the 2001 Trust Law, which specifically recognizes trusts for public interests or charitable trusts. These include trusts for poverty relief, emergency relief, assistance to the disabled, education, science and technology, culture, arts and sports, medical and health welfare, and protection of the environment. The new law lays down a legal framework for charitable trusts that should help mobilize resources for social development and complement the work of NGOs in these areas.

A review of the development of NGOs in the PRC indicates that the following steps need to be taken to strengthen their capacity to participate in social and economic development:

- increase the capacity of NGOs to participate in policy making and in drafting laws and regulations by providing training and additional resources;
- clarify the legal status of NGOs by promulgating a law on NGOs;

- consider permitting NGOs to set up branch organizations in different administrative regions and allowing several NGOs to operate in the same field to improve efficiency through competition;
- encourage NGOs to follow good corporate governance practices suitable for NGOs; and
- continue to welcome overseas NGOs to provide assistance on economic and social development and to partner with local NGOs.

## **2. Access to Information**

The Government recognizes that access to information is critically important to economic development. To this end it has set up radio and television broadcasting networks that cover most of the nation. By 1999, for example, 90.5% of the population received radio broadcasts and 92% had access to television broadcasts, and nearly half a million people were employed delivering these services via 296 radio and 357 television stations. News and educational programs feature prominently in radio and television. By 1999 almost 25% of all television programming was devoted to news programs of some kind, up from 20% in 1985.

The past 20 years has witnessed an explosive growth of the print media. In 1999, 2,038 newspapers were published in the PRC, compared with 188 in 1980. The number of magazines also shot up from 2,191 in 1980 to 8,187 in 1999. The country now has 530 publishing houses that employ about 46,000 people. The central Government controls about two fifths of these presses.

In addition an estimated 33.7 million people are now plugged into the Internet, an increase of 49.8% over 2000, accessing the Web on an estimated 10 million computers. The education level of Internet users is declining, indicating that its use has become more mainstream. In 2001 about 35% of users were university graduates, and 21% of users were based in Beijing, double the number of users in Shanghai. About 40% of those on-line were women and half of all users were under 24 years old.

The Constitution guarantees freedom of speech and of the press (Article 35), freedoms that are bound by the law and exercised under the guiding principles of the State. These principles give the CPC influence over the media, which exercises via the Central Committee's Publicity (Propaganda) Department. The Publicity Department reviews personnel appointments to editorial positions in all significant print and broadcast media, and media workers join the All-China Federation of Journalists, an organization controlled by the CPC. The State Council's Ministry of Information Technology and Telecommunications, set up in 1998, implements official policy on information technology, telecommunications, and post offices, while the State Bureau on Broadcasting, Cinema, and Television and the State Office on News and Publishing implement policy in these areas. It is the State Office on News and Publishing, for example, that under the watchful eye of the Publicity Department approves the establishment of new publishers and new publications and "supervises and manages" news publications and their activities.

Management of the Internet has presented the Government with unique challenges. On the one hand, technology has changed so fast that the Government has to some extent been left behind. Any individual with a computer and a telephone line can plug into the Web. On the

other hand, to preserve social stability the Government has attempted to regulate the content of Web sites, licensing, encryption, and funding sources for Internet portals.

In September 2000 the State Council promulgated rules that sought to limit Internet content and restrict foreign investment in Internet content providers. In November 2000 the PRC published new Internet regulations that limited the news that Web sites and on-line chat rooms could carry. The regulations give the State Council's Information Office the authority to supervise Web sites. Commercial media organizations are prohibited from setting up independent news sites, and commercial Web portals may only carry news from officially approved domestic news organizations, and then only after obtaining government permission, and may not carry any news items that are based on their own sources. Moreover, PRC-based Web sites may not link to overseas news sites or carry news from overseas news media without government permission. The regulations also restrict the content of on-line chat rooms and bulletin boards. Those who run bulletin board systems must first obtain permission from the Ministry of Information Industry or local authorities. The Government has also issued lists of banned topics, including information that is pornographic or violent, spreads "feudal superstition," endangers state security, reveals state secrets, or sabotages unity among ethnic groups. Web portals are required to hire experienced editors to supervise their own sites. In April and July 2001 the Government issued new regulations to control Internet café's and licensing regulations to better manage on-line bulletin boards.

The impact of the regulations has not been particularly severe. On the one hand, the authorities have permitted access to foreign content news related to the economy, especially business news, and for many years large Web portals have worked closely with the Government in establishing their operations. On the other hand, Internet users are resourceful and have found ways to acquire the information they want.

The PRC's experience with the Internet and other media indicates that the Government should keep the effectiveness of and need for restrictions on access to information, including the Internet, under constant review. As the private sector grows, its development will depend to a large extent on its ability to promptly access information about markets and products.

### **3. Summary**

NGOs in the PRC have unique characteristics, some of which are undergoing change. As the product of a transitional period, they have appeared in large numbers in many public policy areas. With the further development of the economy, but limitations on what the State can do, NGOs have the potential to play a greater role in economic and social development. Access to information is critical for informed investment decisions, and even though access is improving, the CPC still plays an important role in controlling what people may read and hear. The Internet is challenging the dominance of the State in the area.

## **IV. CONCLUSIONS AND IMPLICATIONS**

Sound development management is essential for economic and social growth. Only with sound development management can the economy grow, and this is a precondition for achieving other critical goals, such as poverty reduction. The PRC has made genuine progress in improving accountability, participation, and the predictability and transparency of operations in a substantial number of key areas, including public financial management; public administration; legal, judicial, and regulatory systems; public service delivery; public accountability; the public-private interface; and emerging civil society.

### **A. Recommendations for the Government**

To further improve development management and remove remaining largely noneconomic factors that hinder efficient and sustainable economic growth, the Government may consider further reforms in some of the following areas.

#### **1. Public Financial Management**

Reform of public financial management will continue to be critical for improving the system's capacity to develop further. Specific areas of reform include the following.

- (i) Strengthen the revenue generation mechanism, especially the tax collection system, through increased computerization and further reform of the judiciary to strengthen tax enforcement.
- (ii) Evaluate the possibilities of moving toward a consumption-type of VAT. The distortionary nature of the tax system, which relies heavily on an origin-based, production-type of VAT, hampers export competitiveness, penalizes investment, and generates distortions through cascading. The Government should consider replacing the production-type of VAT with another kind of tax.
- (iii) Review enterprise income tax preferences regularly to determine whether they are still needed. The system of tax preferences has been a major drain on government revenues. In many cases the preferences may not be needed to attract investment.
- (iv) Ensure that budgeting is comprehensive and merge off-budget items with the budget to produce a single, consolidated, comprehensive budget that includes capital and all recurrent expenditures. The most important problem of the budgeting system is that it lacks comprehensiveness. Local governments have created off-budget items to help them manage necessary spending that is often mandated by the central Government. Because the budget is not comprehensive, however, the Government is unable to use the budget as a management tool.
- (v) Further develop revenue forecasting by relying more heavily on research organizations that have modeling expertise. More accurate revenue forecasts will permit better planning. While the Government does engage in revenue forecasting, the quality of forecasts could be improved. One way to do this would be to rely, in part, on additional sources of information for forecasts.

- (vi) Strengthen the NPC's role in budget approval and supervision and mandate that MOF consults the NPC on in-year adjustments to the budget. Currently the NPC plays a relatively minor role in approving the budget and supervising its implementation. Strengthening the NPC's role would ensure that all players understood the reasons for the priorities set by the Government, which would smooth implementation.
- (vii) Consider further reform of the system of intergovernmental transfers to ensure that they attack the problem of growing regional income disparities. The system of intergovernmental transfers has not prevented poor areas of the PRC from becoming poorer, and the gap between rich and poor areas seems to be widening. The effectiveness of the intergovernmental transfer system should be investigated with a view to reducing regional income disparities and ensuring that the poor have access to such key services as health and education.

## **2. Public Administration**

The Government has carried out many restructuring campaigns, the most successful of which have been those that sought to change the role of the State to suit a market economy. Attempts to downsize the State have been less successful, and bureaucratic overlaps and unclear lines of authority persist. Because of the importance of financial incentives the Government should consider strengthening MOF's role in restructuring policy making and implementation. MOF and local finance bureaus could play a gatekeeper role, evaluating bids for more resources that take agency spending above certain ceilings. Specific recommendations include the following:

- (i) Strengthen MOF's role in government restructuring to ensure financial discipline and to eliminate bureaucratic overlaps and unclear lines of authority.
- (ii) Eliminate abuses of the civil service, such as buying and selling positions, through more transparency, effective law enforcement, and supervision. Although civil service reform has resulted in a meritocratic selection system, abuses of the system are still quite common, especially at the local government level. A new system to deal with abuses could build on the experience of some provinces in making the selection system more transparent.
- (iii) Rotate more high-quality officials to the disadvantaged west to increase the western provinces' policy and administrative capacities. Such officials might be required to spend time in the west before being considered for promotion. The western region has been disadvantaged in many respects, including in the provision of high-quality human resources. Although there is a rotation system for civil servants, it should be expanded and incentives to encourage high-quality officials from other areas to participate should be increased.
- (iv) Undertake further reform of the civil service compensation to bring government compensation packages in-line with those in the enterprise sector. Policies to monetize all benefits should be accelerated to control costs. The Government should continue to carry out surveys of pay trends in the nongovernment sector and implement effective systems to link pay to performance. Even though the Government increased civil service salaries steadily in the late 1990s and twice

in 2001, they continue to lag behind compensation levels in the private sector. This demoralizes civil servants and attracts corruption.

- (v) Continue the strong campaign against all forms of corruption, including through stronger enforcement of the law and reform of the police, the procurate and the judiciary. The Government's campaign against corruption, which has included arresting and trying senior officials, has been effective. Nevertheless, much more needs to be done to ensure that corrupt practices are wiped out. A weak link in the drive against corruption is the quality of the police and the judiciary. Moves to improve their education levels and remuneration packages should be encouraged.
- (vi) Institutionalize the system of popular participation in policy making by requiring public hearings, opening legislative hearings, soliciting opinions, setting up advisory bodies, and consulting community groups (including NGOs). Government officials have begun to consult not only stakeholders inside the bureaucracy, but also the general public, before making policy. This is a new and welcome development. As a result public hearings, legislative hearings, and opportunities for NGOs to influence the policy process have increased in recent years. These trends should be institutionalized.
- (vii) Promulgate a government information transparency law to clearly define the scope of transparency in government and encourage the Government to become more transparent. To facilitate participation in the policy process, citizens must be well informed about Government policy and the problems facing the community. To this end, a more transparent government is required. Moves to increase transparency at the town and township level should be spread to urban areas and codified in a law that defines the scope of transparency in Government.
- (viii) Attempt to change the administrative culture to more highly value popular participation in policy making by evaluating officials on the extent to which they have consulted the public before they make decisions that affect the public.

### **3. Legal, Judicial, and Regulatory Systems**

Suggested reforms include the following:

- (i) Reduce inconsistencies in the law through more expert law drafting and wider participation in the review of draft laws. While the PRC has progressed much in its capacity to draft laws, including the establishment of expert law drafting bodies within the State Council and the NPC, further capacity building in this area is required. Wider participation in the review of draft laws would reduce inconsistencies and improve predictability.
- (ii) Reduce arbitrary enforcement of the law through stricter quality control in selecting police and procuratorial and judicial personnel, and enhance their training and supervision. Uniform enforcement of the law continues to be problematic in many parts of the PRC. Tighter quality control and supervision of law enforcement agencies and increased training should reduce arbitrary

enforcement. Examining the incentives for reliable and predictable law enforcement is also required.

- (iii) Reduce judicial localism by removing local authorities from decision making about judicial personnel and ensuring the financial independence of local courts. Judicial localism is a particularly serious problem that could be better managed by reducing local courts dependence on local governments.
- (iv) Address the shortage of trained lawyers and judges by expanding legal education and training opportunities and increase the professionalism of lawyers by strengthening the role of professional bodies.
- (v) Establish an effective system for resolving jurisdictional disputes among competing regulatory agencies. The regulatory system has developed rapidly, with many agencies making rules that conflict with rules made by other agencies. A more effective system for resolving jurisdictional disputes among competing agencies is required.
- (vi) Institutionalize a system of requiring regulators to consult with regulated entities in drafting new or revising old regulations.
- (vii) Fund regulatory bodies independently of local governments and ensure their financial autonomy by funding them directly from the central Government. This will enhance the independence of regulatory bodies, especially at the local government level.
- (viii) In line with the recommendation that the Government consider drafting a government information transparency law, it may also consider a more effective system for periodic review of the extent to which previously secret regulations may be made public. These steps are needed to ensure that regulated parties understand what is required of them and that regulations actually achieve their purpose.
- (ix) Draft laws or sets of procedures to govern the operations of government bodies in making and applying rules. Government agencies should be bound by specific procedures to ensure uniformity and predictability.
- (x) Further develop the system of legal aid so that it better serves the poor, including popularizing it in rural areas and in the west. Although many steps have been taken to improve the legal system, they may be ineffective if ordinary people do not have access to it. To address this concern the Government has established a system of legal aid; however, the system needs to be expanded to better serve the poor.

#### **4. Public Service Delivery**

Although the Government has made substantial improvements in its service orientation, further actions are still needed.

- (i) Improve efficiency in providing public services through more competitive market entry by breaking up monopolies, especially in the area of public utilities, and consider promulgating an antimonopoly law.
- (ii) Improve efficiency and local governments' capacity to manage the new systems effectively, replicate the practices of some advanced cities that use alternative public service delivery systems such as contracting out, internal markets, franchising, vouchers, privatization, and public-private partnerships. Using such mechanisms effectively requires new capacities in the public sector. Governments should be required to ensure that they obtain appropriate service quality levels and value for money through improved reporting, supervisory, and contract management capacities in local government.

## **5. Public Accountability**

The PRC has established effective mechanisms for holding officials accountable and has drafted accounting and auditing laws, rules, and regulations that comply with international practice. Enforcing the standards, however, especially in economic enterprises, has been a continuing problem. The Government should make greater efforts to enforce the standards, perhaps by increasing the intensity of auditing, increasing the professionalism of auditors, and introducing stiff penalties for violators. The Government should continue with reforms in its accounting, auditing, and statistical systems, especially by implementing standards based on international practice in both the public and private sectors.

## **6. Public-Private Interface**

The legal and regulatory system for promoting and protecting the private sector has received government attention. Nevertheless much more needs to be done, including the following:

- (i) Further reform the laws and regulations related to promotion of the private sector, for example, the recently passed Law on the Promotion of SMEs and an antimonopoly law. The Government should also enact laws to protect private property and amend the Constitution in this regard. Research projects need to be undertaken that focus on the appropriate regulatory, legal, and economic policies for a healthy private sector.
- (ii) The Government may consider establishing a high-level policy group to improve the coordination, continuity, and consistency of policies for the private sector. Public policy for economic development should be well coordinated, have continuity, and be consistent and predictable? these are especially important for the development of the private sector.
- (iii) Further improve the environment for the private sector by expanding a credit guarantee system and providing microfinance for SMEs.<sup>39</sup> Among the problems facing private enterprises perhaps the most significant is access to credit.

<sup>39</sup>The PRC's top legislators endorsed the Law on SME Promotion and the Law on Promoting Cleaner Production at the 28<sup>th</sup> meeting of the NPC's Standing Committee on 29 June 2002.

Because most private businesses are small, many large institutional lenders are unwilling to provide credit, which they see as high risk.

- (iv) Reorient the Government to a new role of being a service provider to public and private entrepreneurs. This requires the Government to provide basic information about international trade, quality standards, and the domestic and overseas market situation; assistance to reform ownership structures; and help for improving management and upgrading technology.
- (v) Provide more support for NGOs that are promoting the private economy, such as the All-China Federation of Chambers of Commerce. NGOs have an important role to play in the market economy. They have information about the operations of the private sector and are keenly aware of the problems. The Government should develop its relationships with NGOs to better inform policy making and implementation.
- (vi) Improve corporate governance by requiring that corporate management groups be selected according to market mechanisms, not appointment by government agencies. Moreover, managers should no longer be assigned administrative ranks and the selection process should be transparent. Improved corporate governance is critical for economic development. Efficient management of the country's enterprises requires substantially improved levels of transparency and accountability. Management decisions should be driven by market forces.
- (vii) Reform the ownership structure of SOEs by reducing state shareholdings, selling government assets, opening access to private investment, and attracting capital investment from nongovernment sources. In addition, the Government should increase the transparency of the ownership structure and ensure the rights of minority shareholders.
- (viii) Strengthen the requirements for transparency of financial statements of public and private corporations and enforce the new standards effectively.
- (ix) Link the remuneration packages of managers of SOEs to their performance (for example, share value or profitability) and increase compensation packages to better reflect their responsibilities. Remuneration packages should also be more transparent. Motivating managers is critically important for the sound development of the economy, especially in the corporate sector, where compensation has traditionally been linked to administrative rank or the scale of an enterprise, not its performance.

## **7. Civil Society**

In recent years the PRC's policies have focused on partnering with civil society to expand the Government's capacity to solve social problems. The roles of the PRC's unique NGOs have increased substantially, providing an increasing array of services. The Government also regulates and supports them. Nevertheless, further improvement could be possible by means of the following:

- (i) Increase the NGOs' capacity to participate in policy making and in drafting laws and regulations through training and the provision of additional resources.

- (ii) Re-examine the policy of restricting NGOs geographically. The Government should consider permitting NGOs to set up branch organizations at lower administrative levels and allowing them to operate in more than one administrative jurisdiction. It should also consider allowing more than one NGO to operate in the same field or scope of operations so that they may compete and the best ones can grow and prosper.
- (iii) Encourage NGOs to follow good corporate governance practices. To this end the Government should not only lay down appropriate rules and regulations, but should help NGOs meet these challenges.
- (iv) Promulgate a law to give legal status to NGOs. Clearly defining the role and legal status of NGOs would remove uncertainties and permit NGOs to develop further.
- (v) Keep the effectiveness and need for restrictions on access to information, including the Internet, under constant review. Access to information is critically important for the development of the economy. Investment, pricing, and market decisions all depend on accurate information delivered promptly. The PRC's media management should balance the needs for social stability on the one hand, with the needs for the free exchange of information on the other.

## **B. Recommendations for International Funding Agencies**

The Government has established its own development management priorities and may wish to invite assistance from bilateral and multilateral development partners (see Appendix 3 for a list of current and ongoing projects). Opportunities for collaboration exist in each area of development management. First, in the area of public financial management, multilateral agencies such as the World Bank and the International Monetary Fund have been involved in providing assistance for improved public financial management for many years. International funding agencies could continue to be involved in reform of the taxation system, budget reform, assistance to develop more effective forecasting models, and assistance to study improvements to the system of intergovernmental transfers. They may also consider providing assistance for broadly based training programs that provide training in the concepts and practices of good community governance, including financial management, service delivery, legal and property rights, public investment, community planning, improving institutions, and human resource productivity. Strengthened local governance capacity is especially needed in the western regions.

Second, scope for collaboration in the area of public administration could focus on helping the Government reduce and eliminate corruption. The Government has made substantial progress in this area, and assistance is welcome. International funding agencies may consider technical assistance to encourage drafting laws that require public hearings and other forms of participation in policy making and that lay down processes for the hearings. They may increase support to the Discipline and Inspection Commission, the Party's policy-making body for anti-corruption, the national security system, the judiciary, the Procurate (from national to county levels) and the Ministry of Supervision, in charge of supervising public administration. They may also consider providing support for drafting laws to break up monopolies and foster competition.

Third, funding assistance with drafting and reviewing drafts of laws may be considered. International funding agencies could also help with developing a more reliable citizens' complaint system and providing additional training for lawyers and judges. International funding agencies might consider assisting the Government to establish more effective consultative mechanisms in drafting and reconsidering regulations. International funding agencies may also consider assisting government agencies to draft their own procedures for making and applying rules and consider assisting the expansion of legal aid systems in the west. To strengthen the regulatory system, continuing reform of the statistical system is also necessary to ensure that investment, pricing, and marketing decisions are based on accurate information. International funding agencies may consider working with the NBS or local bureaus to improve the collection and handling of statistical data.

Fourth, many international funding agencies have experience in providing assistance to support alternative public service delivery, under the rubric of new public management systems. Small projects could be established, especially in the west, to experiment with some of these systems, while at the same time strengthening local governments' capacity to manage the systems effectively. Training of local officials would be needed.

Fifth, development of the private economy is moving ahead, but is still restricted by the country's traditional preference for the public sector. International funding agencies can assist by carrying out joint projects with NGOs that are committed to the private sector, such as the All-China Federation of Chambers of Commerce. International funding agencies could also help provide credit guarantee systems and microfinancing for SMEs. This could be done through a commercially viable vehicle to demonstrate the opportunities to other potential lenders.

Sixth, international funding agencies have already provided some assistance in the area of corporate governance, but much more could be done (see Appendix 2). Agencies may consider projects in particular corporations to encourage managers to adopt international best practices. International funding agencies could also assist in designing incentive systems for the implementation of appropriate corporate governance structures. They may also consider providing assistance for regulators such as the China Securities Regulatory Commission in designing packages of incentives for implementing corporate governance best practices.

Seventh, some international funding agencies, such as the Ford Foundation, have specialized in providing assistance to strengthen civil society and the capacity of NGOs in providing services to the public and helping the Government implement policy. Projects that focus on particular NGOs in specific geographic regions have been the norm. Perhaps a more holistic approach to the development of NGOs is now called for, which looks at issues such as their capacity to participate in policy making to improve the effectiveness of public policy.

### **C. Implications for ADB Action**

To determine ADB's program of action for the PRC, resources should be targeted to interventions where ADB governance work can contribute important contribution to poverty reduction, where there is strong Government ownership of and long-term commitment to the development agenda, and where ADB's comparative advantage and value-added can be clearly demonstrated.

The development management agenda in the PRC is large, and to be effective ADB should focus on a few areas identified by the Government and build on ADB's expertise and strengths. ADB has been particularly effective in areas such as reforming public finance,

banking supervision, and risk management; strengthening government auditing and accounting systems; assisting with legal reforms, especially with economic laws, for instance, amending company law and drafting a new bankruptcy law, and with regulatory reform, such as drafting securities law; and assisting in the further growth of the state business and the private sector through further development of the insurance sector, SME credit systems, and financial policy mechanisms for SOEs.

Given the Government's aid management system, which restricts borrowing for projects that do not generate revenue, ADB will be restrained from lending for governance initiatives and will need to mobilize concessional cofinancing to be involved in any major governance loans. Therefore ADB should look for opportunities to leverage the use of scarce resources through strategic alliances and partnerships with other international funding agencies and the effective use of trust funds and other complementary financing schemes.

ADB's technical assistance activities in the PRC will also face resource constraints. The potential technical assistance budget allocation for Governance TA work in the PRC will be approximately \$2 million per year. To expand the modest available resources ADB will need to adopt a three-pronged approach: (i) improving the governance components of its infrastructure loans (for example, for privatization and tariff reform) and reducing extrabudgetary fees; (ii) increasing the PRC's participation in regional and subregional technical assistance initiatives, for instance, Anti-Corruption Action Plan, Decentralization, and Harmonization of Customs Procedures; and (iii) adopting a methodology that relies on high-impact interventions at the policy level and on policy dialogue to promote necessary reforms. ADB will need to work closely with the Government to identify strategic areas for significant impact under advisory and economic and sector work.

Given the importance of improving the institutional and legislative infrastructure for building a market economy, ADB should continue its work to help the Government draft procedures for government agencies on making and applying rules. It should also continue its work to strengthen public financial management institutions, particularly at the subnational level, draft economic laws (such as a revision of the 1995 Budget Law), and strengthen the regulatory framework for a market economy. ADB can also be effective in promoting a rules-based, international standards environment for business.

Developing the west and facing the challenges of the WTO membership are high priorities for the Government and should continue to be reflected in ADB's program of action. ADB is currently providing assistance to help the Government revise laws and regulations that are in conflict with the WTO. The PRC has a mediation system for resolving disputes that works well; however, as the PRC is further integrated into the world economy through accession to the WTO, the significance of the formal court system will likely increase, especially for resolving commercial disputes.<sup>40</sup> Support to improve the courts' capacity for dispute settlement or similar projects should be considered. In the future ADB should make efforts to ensure that policy recommendations and structural reforms in its sector loan work are consistent with the WTO rules.

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<sup>40</sup> Effective 1 October 2002, the supervision powers of the courts extend to cover administrative cases involving international trade. In an effort to better protect the rights of local and foreign litigants, any person or group suspecting a violation of their rights by government departments—in regard to international trade—will be entitled to bring these before the courts.

As the courts become more important, further development of the country's legal aid system to permit all citizens, including the poor, to access the courts will be necessary. Given ADB's expertise in legal and regulatory areas it may consider assisting further development of the legal aid system, especially in the west. Such a project would clearly assist the poor.

Although the Government has waged a fierce struggle against corruption, more remains to be done. ADB has successfully provided assistance for the development of the accounting and audit system, which is critical for accountability. Further reform in this area to strengthen the capacity of the CICPA and other professional organizations to regulate the profession and raise accounting and auditing standards is necessary. ADB should also continue its efforts in encouraging the PRC to become a signatory to the ADB-Organization for Economic Co-operation and Development Anti-Corruption Action Plan and the ongoing initiative involving 18 signatory Asian countries that are implementing country-specific reforms.<sup>41</sup>

Development of the private economy in the PRC is moving ahead, but is still restricted by the country's traditional preference for the public sector. ADB can assist by continuing to sponsor and publicize research on impediments to the development of the private sector and through its work on the reform of economic law and regulation to ensure a more level playing field. Creating a more competitive environment will bring about the redundancy of ineffective SOEs more quickly. Thus ADB may also help accelerate SME development by helping the government become more of a service provider to SMEs by providing marketing assistance, export insurance, consumer surveying services, advertising services, training, and increased capitalization of SMEs through innovative financing windows. This could be done through ADB's Private Sector Department funds as a viable vehicle for demonstrating the opportunities to other potential lenders and could be focused on the west.

In addition to these more traditional activities for ADB, two additional areas are important to development management in the PRC. First, developing sound corporate governance practices is crucial for further economic growth. ADB may assist government departments in designing appropriate incentive systems for implementing sound corporate governance structures. ADB can also assist utilities regulators through utilities loan projects in designing packages of incentives for implementing corporate governance best practice. Second, intergovernmental fiscal reform should be part of ADB's strategic policy agenda. Providing policy influence through modest technical assistance support to institute a better fiscal transfer system in the PRC could have far-reaching impacts.

Finally, ADB should continue to improve its connectiveness to civil society, increasing its legitimacy by involving it in consultations and supporting NGO conferences. Where possible ADB can strengthen their capacity by contracting services in loan projects to NGOs, supporting them to undertake domestic consultancies, and commissioning economic and sector work to civil society research institutes. NGO participation in ADB projects would demonstrate their potential effectiveness as alternative suppliers in service delivery and development work to the Government.

<sup>41</sup> RETA 5999's ADB-OECD Anti-Corruption Initiative - "Anti-Corruption Action Plan for Asia and Pacific" is available on ADB's website and has been translated into Chinese.