

China's Governance in Transition

What is the state of governance in China today?

What should the state's role be?

How to modernise the tools of government?

How to co-ordinate different levels of government?

Is the institutional framework for market forces adequate?

What of the future?

For further information

For further reading

Where to contact us?

Observer^{oecd}

Introduction

China's economic reforms over the past two decades have brought remarkable growth, the development of a vibrant private sector and significant reform of the state-owned sector. Private businesses now represent some 57% of GDP, and productivity in the state-owned sector has improved significantly.

However, a number of problems threaten to undermine prospects for sustainable growth. These notably include social tensions, partly due to increasing inequality within society and massive migration to the cities, but also linked to corruption, insufficient public services and rising unemployment as millions of workers have been laid off in the reform of the state-owned sector, while agriculture still displays huge structural under-employment.

Economic growth alone will not solve all these problems: improved governance is crucial. If China's development is to be sustainable, the government needs to undertake a comprehensive programme of far-reaching institutional reforms to define the role of the state, improve management of public spending, and make public action more efficient and effective.

OECD members had identified governance as a priority topic for their ongoing co-operation programme with China, and to help meet these challenges, the OECD undertook a study of China's governance system, with China's agreement. Although the overall Chinese context remains very different from that of OECD countries, much can be learned from OECD reform experience. The project took stock of progress so far and examined remaining problems in budget processing and public expenditure, the tax system, the civil service, the fight against corruption, regulatory management and organisational structures. It also looked at how governance issues affect policy making and its effectiveness in 10 key sectors: labour policies, banking, competition, intellectual property rights, foreign investment, statistics, corporate governance, agriculture, environmental protection and higher education.

This Policy Brief looks at the lessons learned and the key governance challenges facing China in the coming years, seen from an OECD perspective. ■

What is the state of governance in China today?

China's rapid change is not only visible in the flourishing private sector enterprises and the radical renewal of its urban landscapes: it can also be seen in the transformation of its institutions. Over the past 25 years Chinese authorities have taken measures to adapt the role of government and public administration to an increasingly market-driven economy.

The administrative, productive and social service functions previously folded into a structure of closely linked organisations have been dispatched to different public and private organisations. State-owned enterprises have been separated from the public administration and new regulatory bodies have been set up. Chinese authorities have laid bases for modern tax, budget and civil service systems. China has also taken steps toward a system based on the rule of law, and has embarked on an ambitious regulatory reform programme.

Progress in governance was achieved in a relatively short period of time and has contributed in a crucial manner to sustain China's high growth rate. Such achievements are all the more commendable since the sheer size of China requires longer chains of command and multiplies the sources of potential problems.

In order to continue in this direction, China needs to sustain reform efforts in four key directions: the role of the state; the tools of government; relations between levels of government and the institutional framework for market forces. ■

Box 1

CHINA'S REFORM THEORIES

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

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

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

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

What should the state's role be?

The fundamental issue is to redefine the role of the state. Much has been achieved but, overall, the state needs to focus its efforts on areas where markets cannot accomplish national objectives.

In particular, the government needs to increase public expenditure in education, health, science and technology; improve the governance framework in sectors in which the state will remain active; overhaul the way it organises and manages public services; and tackle problems where new structures are operating alongside those inherited from the old system.

Public spending is currently too low in three key areas: education, where it is below the target of 4% of GDP fixed by the government; science and technology, where building a national system of innovation is crucial; and health, where private capital alone is unlikely to meet the increasing need for services. These gaps are important both for economic growth and for social cohesion.

China also needs to reduce spending on public sector administration. It is not easy to cut the public labour force, since in the poorer areas, public sector employment functions as a social safety net. But further efforts are needed.

The Chinese state will remain active, if not dominant, in a number of sectors. Important steps have been taken to change the governance framework of this participation, in particular by creating several regulatory bodies. But further efforts are needed in three key areas. Firstly, regulatory bodies need to be sufficiently independent from the entities they regulate. Secondly, there has to be enough distance between government authorities and regulatory bodies. And thirdly, the government needs to clarify its relationship with the regulators. It is also important to clearly identify the division of responsibilities between the different regulatory bodies.

The reform of public service units (PSUs), which deliver services such as health, education, science and technology, is a pressing issue. The stakes are high: there are 1.3 million PSUs employing some 25 million people. Before the reforms, they were owned and managed by the government, receiving funds from the budget to finance all their operations. They now have more autonomy to help deal with growing demand and insufficient public funding, but this has led to an increasingly complex situation.

Higher education institutions, for example, now receive only half their budget from public funds, with the rest coming from sub-national budgets, student fees and private sector contracts. The number of students has increased fifteen fold in 10 years. But relying heavily on private financing tends to increase social disparities, as higher education becomes accessible only to those who can afford it. It is also difficult to monitor quality and efficiency.

The government is embarking on an important reform of PSUs to clarify the role of the state, improve performance, and clarify management and accountability to ensure the PSUs serve the public and not themselves.

The reforms to date have also created problems where new institutions co-exist with structures inherited from the past. The government needs to deal with lack of co-ordination between closely related organisations and those whose mandates overlap, cases where hierarchical structure between organisations does not correspond to their mandates; fragmentation of decision-making responsibilities; and the co-existence of institutions with conflicting mandates. ■

**How to modernise
the tools of
government?**

China needs to modernise the regulatory framework and public management system – and adapt them to a market-driven economy if it is to use public resources more efficiently. This means producing clearer, less complex regulations and enforcing them, as well as reforming the budget process and the civil service and stamping out corruption.

China has improved the regulatory framework, strengthened the rule of law and in many respects, such as intellectual property rights or individual employment contracts, has adopted regulations well in line with international standards. But enforcing the rules remains a major challenge.

The government has significantly reduced the number of activities requiring administrative approval or licences and has streamlined the investment approval process. But many activities are still subject to a large amount of government control. The Chinese state should further reduce its intervention and shift the emphasis to providing services and infrastructure.

Efforts to streamline the regulatory framework of private businesses should be pushed further. China's moves to simplify administrative regulations in taxation are commendable but there is still a long way to go.

But the main challenge in this area is applying and enforcing regulations. Laws and regulations are not applied in a systematic way, and can be biased by corrupt arrangements or local balance of interests. A lasting solution requires strengthening formal systems of financial and performance audit, and improving the judicial system.

In addition and more fundamentally, if regulations are to be successfully applied and enforced, those being regulated must basically be willing to comply. This depends not only on punishing violations, but also on the quality of regulations and public participation in creating, applying and enforcing them, which in turn implies access to information. The nature of the political regime necessarily places constraints on possible progress in public participation and access to information. The government has taken positive steps on access to information, in part linked to the WTO accession process. But progress is uneven at the local level.

China has made progress in creating the infrastructure for a modern budget management system and civil service, the two principal pillars of public management, along with e-government and simplifying administrative procedures.

But several weaknesses still afflict the budget system, not least the fact that the finance ministry does not have comprehensive oversight authority on spending. So far the government has focused mainly on tackling technical issues, and has shied away from reforms that more directly involve political challenges. In particular, there has been little public discussion of the need for a major realignment of the intergovernmental fiscal system. Other important steps for the future include refocusing budget priorities and limiting policy initiatives which are not disciplined by the budget process.

The Chinese government has undertaken extensive reforms to its civil service system over the past 10 years but many challenges remain. One is to ensure that the rules for recruitment, reward, promotion, etc. are applied. At present, not all recruitments go through the established mechanisms.

Such administrative reforms are necessary to enable China to introduce a unified information technology system. But the success of e-government programmes depends on progress on other fronts, including administrative reforms that standardise operational procedures and clarify responsibilities, and strengthening the rule of law.

Finally, corruption is one of the most important problems in China today. China has undertaken a number of measures to more effectively detect and punish corruption. Reforms have primarily focused on the penal regime as well as on the disciplinary system for officials and Party members. More attention should be paid to reviewing areas prone to corruption, eliminating opportunities for corruption and creating conditions conducive to ethical behaviour. ■

How to co-ordinate different levels of government?

Adjusting the relations between levels of government is equally important. Finding a way to ensure that local governments have the resources to meet their responsibilities and use them in accordance with national objectives is a major governance challenge in China as in OECD member countries.

Although in theory central government has fiscal control over local governments, there are persistent enforcement problems at local level. There are also tensions due to inadequate public services at local level, rising inequalities between provinces and between rural and urban areas, corruption, mismanagement and imposition of illegal taxes.

Divisions of responsibility and accountability are often unclear. Take land ownership rights. These are not clearly defined and authority over them is diluted across various levels of government, leaving considerable scope for arbitrary decisions by local leaders.

Local governments have taken on major new expenditure responsibilities in recent years such as education and health, but without receiving the funding to meet them. To make matters worse, local governments are not always consulted about central government policies that will cost them money. Most local officials reportedly learned of a salary increase for civil servants from TV broadcasts even though the costs were mostly borne at local level. But consultation with local governments has clearly improved in recent years. For example, recent reforms in rural fees and agricultural taxes have been worked out with local governments.

The shortage of revenue at local level makes it difficult to implement national policy on social security, basic education and health. Health ministry figures show that the 900 million rural Chinese receive only 20% of the country's medical resources although they account for 70% of the country's population.

A major consequence has been the growth of illegal taxes and fees, as well as corruption. When pay is seriously in arrears, for instance, there is great temptation to use official power to extort bribes.

These problems are all the more important in an increasingly market-driven system, which tightens budget constraints and increases pressure for efficiency.

Reforms have been undertaken to reinforce vertical lines of authority in various areas, notably the tax system. But improving co-ordination between the central and local levels will also require progress on other fronts: improving sub-national

Is the institutional framework for market forces adequate?

governments' capacity to properly handle new responsibilities, developing external control mechanisms at local level, reforming incentive mechanisms for local leaders, and increasing participation of local leaders in debates on national policies. ■

Market-driven economies need just as many institutions as planned economies, albeit of a different type, covering areas such as the labour market and labour protection, tax system, sound competition rules, intellectual property rights and corporate governance.

China's economic reforms have established a new relationship between enterprises, workers and the state, shifting the government's responsibility toward promoting efficient labour markets and replacing the "iron rice bowl" with a social safety net.

Specialised labour office networks have been developed in urban areas, but much less so in rural areas, where further rapid expansion will be needed. The labour inspectorate supports the enforcement of labour policies, not least by responding to individual workers' complaints. But limited social insurance coverage and labour protection contribute to continued labour market segmentation that distorts the competitive climate and income distribution.

Implementing labour law and social insurance is generally difficult in the less-productive rural and informal segments of the labour market. But the present scale of rural-urban migration and economic interdependence makes it urgent to reduce the inequity of the system as far as possible. The pension programme, for example, currently requires 10 contribution years in the same locality, but should be equipped to take account of all contributions made by an individual during his or her lifetime, regardless of where they were paid.

Competition is recognized as key to economic efficiency. Key areas of a sound competition framework include tax policy, competition policy and intellectual property rights. A new round of tax reform is now needed to bring the tax system up to date. Based on the experience of OECD member countries it would be beneficial for China to follow the example of many transition and developing economies and progressively adopt a national competition policy.

When it comes to intellectual property rights (IPR), in the past two decades, China has adopted a set of laws and regulations that basically conform to current international practice and standards. The main continuing problems are lack of transparency at local level and enforcement. A Chinese official report estimated that counterfeit goods worth between USD 19 billion and USD 24 billion were on the market in 2001 alone – an amount comparable to the GDP of Tunisia. OECD countries' experience suggests that enforcement campaigns alone will not solve the problem. China needs a multidimensional strategy, which would include reorganising the enforcement system and raising participation of non-government groups.

Corporate governance is also vital. Traditionally there have been different sets of rules for state-owned entities, collective enterprises and foreign-invested companies, although the authorities have made much progress in recent years toward placing all businesses on a comparable legal and regulatory basis. A

comprehensive change in company law now being drafted is expected to largely complete this process.

China has to a certain extent brought its corporate governance codes for listed companies into line with international practice. However there remain some important gaps. Many state-owned assets lack boards and other essential governance structures. Chinese authorities have long recognised the critical importance of stock markets in underpinning the effective corporate governance of listed companies. Until fairly recently, though, the stock markets were used more to support state-owned enterprises than to encourage private business or bolster corporate governance. The government has been making vigorous efforts to address the weaknesses and is putting into place a new regulatory framework for listed companies aimed at protecting investors' interests and based on the principles of "transparency, fairness, and justice". Nevertheless, much remains to be done, particularly in terms of enforcing existing laws and regulations.

Corporate governance of banks presents special challenges. Banks in China have been moving away from their passive role in allocating credit according to state directives under the planned economy. But in most cases their ownership structures and governance regimes are not yet adequate to allow them to serve as purely commercial entities. This is particularly important in the case of the four large state-owned commercial banks which account for the predominant share of bank assets. Strong efforts are being made to improve the corporate governance of these banks by converting them into commercial companies with modern governance structures. But it is unclear how far the reforms will go toward making them operate as market-based institutions. ■

What of the future?

Governance reforms, in China as everywhere else, happen incrementally, when favourable political circumstances coincide with technical capacity. On all the identified governance weaknesses, China will need to ensure that it has the technical know-how to proceed as and when the circumstances allow. Although the overall Chinese context remains very different from that of OECD member countries, much can be learned from these countries' reform experience. Through extended exchanges with OECD practitioners and experts, China could draw lessons on various technical aspects of the system of governance as well as on implementation strategies. ■

For further information

For further information about the OECD's work on governance in China, please contact: Irene Hors, e-mail: Irene.hors@oecd.org, Tel: (33) 1 45 24 15 25; for public sector management and performance: Nick Manning, e-mail: nick.manning@oecd.org, Tel: (33) 1 45 24 16 45; for regulatory policy: Josef Konvitz, e-mail: josef.konvitz@oecd.org, Tel: (33) 1 45 24 97 47; for budget and public expenditure: Barry Anderson, e-mail: barry.anderson@oecd.org, Tel: (33) 1 45 24 90 85; for innovation and integrity in the public sector: Christian Vergez, e-mail: christian.vergez@oecd.org, Tel: (33) 1 45 24 90 44



For further reading

- OECD, 2005, **China in the Global Economy: Governance in China**, ISBN 92-64-00-84-46, 41, 350 pages.
- OECD, 2005, **OECD Review of Agricultural Policies: China**, ISBN 92-64-01-26-05, 50, 303 pages (forthcoming).
- OECD, 2005, **OECD Economic Survey: China**, ISBN 92-64-01-182-X, 42, 270 pages.
- OECD, 2004, **China in the Global Economy: Income Disparities in China, an OECD Perspective**, ISBN 92-64-01-72-08, 58, 228 pages.
- OECD, 2004, **China in the Global Economy: Rural Finance and Credit Infrastructure in China**, 70, 392 pages.
- OECD, 2003, **OECD Investment Policy Reviews: China, Progress and Reform Challenges**, ISBN 92-64-10-19-50, 34, 240 pages.

OECD publications can be purchased from our online bookshop:
www.oecdbookshop.org

OECD publications and statistical databases are also available via our online library:
www.SourceOECD.org

Where to contact us?

OECD HEADQUARTERS

2, rue André-Pascal
75775 PARIS Cedex 16
Tel.: (33) 01 45 24 81 67
Fax: (33) 01 45 24 19 50
E-mail: sales@oecd.org
Internet: www.oecd.org

GERMANY

OECD Berlin Centre
Schumannstrasse 10
D-10117 BERLIN
Tel.: (49-30) 288 8353
Fax: (49-30) 288 83545
E-mail:
berlin.contact@oecd.org
Internet:
www.oecd.org/deutschland

JAPAN

OECD Tokyo Centre
Nippon Press Center Bldg
2-2-1 Uchisaiwaicho,
Chiyoda-ku
TOKYO 100-0011
Tel.: (81-3) 5532 0021
Fax: (81-3) 5532 0035
E-mail: center@oecdtokyo.org
Internet: www.oecdtokyo.org

MEXICO

OECD Mexico Centre
Av. Presidente Mazaryk 526
Colonia: Polanco
C.P. 11560 MEXICO, D.F.
Tel.: (00.52.55) 9138 6233
Fax: (00.52.55) 5280 0480
E-mail:
mexico.contact@oecd.org
Internet:
www.rtn.net.mx/ocde

UNITED STATES

OECD Washington Center
2001 L Street N.W., Suite 650
WASHINGTON DC. 20036-4922
Tel.: (1-202) 785 6323
Fax: (1-202) 785 0350
E-mail:
washington.contact@oecd.org
Internet: www.oecdwash.org
Toll free: (1-800) 456 6323

The OECD Policy Briefs are prepared by the Public Affairs Division, Public Affairs and Communications Directorate. They are published under the responsibility of the Secretary-General.