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THE REFORM OF PUBLIC SERVICE UNITS: CHALLENGES AND PERSPECTIVES

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TABLE OF CONTENTS

I. PSUs: A default organisational category under reform ................................................................. 4
  I.1. The evolution of PSUs .............................................................................................................. 4
  History ........................................................................................................................................... 4
  Earlier reforms ............................................................................................................................... 4
  I.2. The PSU problem today .......................................................................................................... 5
  The budget question ....................................................................................................................... 5
  The performance question .......................................................................................................... 5
  The question of the role of the state and its organisational forms .................................................. 6
  I.3. Current reform efforts ........................................................................................................... 6
  I.4. Looking ahead ....................................................................................................................... 7
II. The experience of OECD countries ............................................................................................. 8
  II.1. A diversity of experiences ...................................................................................................... 8
  a. Diversity in the scope of government intervention in ownership and funding of public services in 3 of the most important sectors involved in PSU reform ........................................ 8
  b. The education sector ............................................................................................................... 8
  c. Research .................................................................................................................................. 10
  II.1.b. The experience of OECD countries with the delivery of public services by government owned entities .................................................................................................................. 11
II.1.c. The experience of OECD countries with the delivery of public services by private sector organisations ................................................................................................................. 14
  II.2. General lessons learnt from OECD countries ........................................................................ 16
  a. Identify the public interest and divest from activities where there is no clear public interest ....... 16
  II.2.b. The right organisational forms for the delivery of activities where there is a public interest ................................................................................................................................. 16
III. Key future reform challenges for China ..................................................................................... 19
  III.1. Clarifying the problems and challenges at stake .................................................................. 19
  III.2. Balancing coherence and diversity ...................................................................................... 19
  III.3. Applying appropriate reform levers ..................................................................................... 20
  III.4. Considering wider issues of governmental capacity .............................................................. 20
Conclusions ...................................................................................................................................... 20
THE REFORM OF PUBLIC SERVICE UNITS: CHALLENGES AND PERSPECTIVES

Introduction

1. China’s large and diverse sector of “public service units” (PSUs -- shiye danwei) is a galaxy of public service providers that have been developed alongside Chinese core government and in parallel with state-owned enterprises (SOEs), state owned financial institutions and state-sponsored “social organisations”. Their reform represents the third stage of China’s long term strategy to transform its public sector into a state assisting the socialist market economy, after the reforms of SOEs and core government reform.

2. PSUs are one of the four categories of legal persons defined in China’s General Rules for Civil Law. In the Interim Regulations on the Management of Public Institutions (PSUs) registration adopted in 1998, it is stipulated that “the public institution is an organization with the provision of social services in nature, established by the governmental agencies or other organizations with the state-owned assets, working for the public good activities such as education, science and technology, culture and health”. Current organizations classified under the PSU category include some that are engaged in profitable economic activities or governmental administrative functions.

3. Today, there are 1.3 million PSUs, employing 25.5 million people, more than half of the best educated people in China and approximately 1/3 of staff working in the public sector. Preliminary data show PSU activities probably represent 5-10 percent of China’s GDP. Education (schools, universities) and health (primary care centres, hospitals) account for more than 60 percent of PSU total employment.

N.B.: Part of the research behind this paper was carried out through a joint activity with the World Bank leading to the organization of a joint conference with the World Bank and the National Development and Reform Commission in Beijing on March 23-24, 2004 and entitled “International Experience with Public Service Reform and China’s PSU reform”. In addition, some of the data included in this note draw on draft papers by the World Bank. Their collaboration is gratefully acknowledged.

1 The other three basic forms of legal persons are: enterprises, government organs (Jiguan), and social organizations (Shetuan). « Reform of China’s public institutions : Retrospect and prospects », by project team on « Reform of China’s public institutions and development of China’s nonprofit organizations », National Center for Science and Technology for Development

2 id.

3 Data are for end 2001

4 China Statistical Yearbook, 2002. Another estimate from the Second National census of basic units found 26.5 million employees in 718,930 PSUs at the edn of 2001. It also reports 116,991 PNEUs with a total employment of 1.2 million at the same time.

5 Data from the Ministry of Personnel.
However, PSUs are characterized by their diversity in terms of services provided, governance structure, financing arrangements, relationship with government.

4. PSUs have been under reform for almost 20 years to improve their efficiency. Reform started in a piecemeal fashion in the 1980s, focusing on granting additional autonomy to managers and employees of PSUs while encouraging PSUs to find non budget subsidy revenues and increasing labor market competition. Present reforms aim more at classifying, commercialising what can be commercialised and restructured the rest. In fact, as part of the transition from a central planning economy to a market economy, the reform of PSUs will be at the core of re-defining the size and role of government in the economy, as well as defining its modes of operating and funding mechanisms.

5. This paper will give an overview of the evolution of the PSUs in the last two decades and the challenges at stake. It will invoke the experience of OECD countries to the extent that it be useful, and suggest what main lines of reforms that could be taken by the Chinese authorities to make PSUs into modern institutions appropriate to an opening economy.

I. PSUs: A default organisational category under reform

6. PSUs have been inherited from a formerly centrally planned socialist economy. They have formal control rules that are different from core government organisations, and strong ties to the party and the state in terms of ownership and control. They form a default organisational category that has built over the years and has been under piecemeal reform for two decades. The government is now trying to take a whole of government perspective and change the PSU organisational structure to better match its new role in a modern market economy.

I.1. The evolution of PSUs

History

7. While some few PSUs date back to the early days of the Communist Party and the Army or the nationalist government, most have been created under the planned economy under a rather simple regime, where they were to provide the goods and services as defined under the planned economy in certain quantities and of a certain quality. The main difference between PSUs and State Owned Enterprises (SOEs) was a functional difference in that PSUs were to provide mostly social and intangible goods while SOEs were to provide mostly tangible and economic activities. SOEs were expected to offset their costs through trading activities, whereas PSUs were mostly funded through direct transfers from government.

8. The management of the sector developed to fit the requirements of a planned economy and has a highly centralized policy and resource allocation apparatus. PSUs did not raise their own revenues and many did not have an independent accounting system. They were under strict hierarchical rules from reporting entities, either local or national. Their staff were under civil service personnel establishment control, and their activities were conducted strictly according to state plan.

Earlier reforms

9. Reform started in the mid 1980s with successive sectoral reform policies in the fields of science and technology, education, culture and arts, sports and health. Until the mid-1990s, reforms aimed at increasing the capacity of PSUs to raise their own revenues by limiting government direct funding to cover just basic salaries, and giving tax incentives to PSUs earnings. PSUs were given an independent accounting system and some management autonomy in some cases. Some of their staff have been put on contracts giving their employers more capacity to lay off their staff.
10. Some staff were encouraged to sell their services “in the market” (to public or private organisations) negotiating sharing arrangements for the revenues generated. The PSU sector was also encouraged to open up to non PSU and non state sector entities, allowing joint work with enterprises, and mergers and cooperative agreements among PSUs across the boundaries of ministries and provinces etc. At the same time, privately-owned entities have also been encouraged to participate in sectors previously monopolised by PSUs. This resulted in the emergence of some private schools or hospitals.

11. There is little doubt that this strategy has been relatively successful at raising extra budgetary revenues for some PSUs. However, they have not been sufficient for increasing the efficiency of PSUs as most PSUs do not operate in contestable markets, and their reporting mechanisms do not allow good control of performance for measurable and contestable goods. Successful reform would have required an overall reflection on the role of the state and its organisational forms in government activities, and strong governance mechanisms established in exchange for market incentives.

I.2. The PSU problem today

12. It seems that today, PSUs are benefiting both from their former status in the planned economy where they received automatic budget appropriations, and also from the market economy by being able to raise their own revenues and get involved in more commercial businesses. This has resulted in a situation where the accountability mechanisms provided in the formerly planned market economy have weakened while the market incentives are not yet functioning properly. This is a common problem of public management reforms driven by market incentives. Considering the size of the PSU sector, it was urgent that the Chinese authorities changed their reform strategy in the sector.

The budget question

13. The cost of PSUs has grown rapidly after the reforms. Data from the ministry of finance show that the total revenues of PSUs now account for 1.38 trillion yuan, roughly 2/3 of whole government spending. In terms of numbers, 40% of PSUs live on national budgets while 60% live on local government budget (55% of their assets are the state’s, and 45% are mapped to local governments).

14. Extra budgetary revenue has also increased and continues to grow rapidly, while budget support has also significantly increased. Today, approximately 20% of PSUs are self-financed, and overall, initial data show that non budgetary financial allocations represent approximately half of total revenue of PSUs today.

15. Pensions are an important liability for the future of PSUs. The vast majority of PSU employees receive pensions on a pay as you go basis. These pensions are funded from current revenues and are escalating at a worrying rate. This is a very important factor that will have limiting consequences on PSU reforms in the next years.

The performance question

16. Despite this growth of non budget revenue, it does not seem that efficiency has increased. Not only has the total number of employees significantly increased, but the overall budget support per employee has also increased. Some data point to a continued significant increase of this ratio in the last few

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6 Most data are from the Ministry of Finance
years, even very recently. This seems to be particularly so for PSUs at local government level, which employ 70% of PSU staff while they only represent 30% of PSUs’ overall budget.  

17. Many observers consider that non budget revenue has constituted private rents for PSUs that have been used in ways that are not always in accordance with the general interest or with government policy.  

18. The additional autonomy granted to PSUs has allowed them to use their budgets with more freedom, without clear accountability for results or outputs. Since 1996 at the national level, budget has been allocated in two parts: basic funding is negotiated between the MOF and the reporting ministry—often based on staffing numbers, and the second part is allocated for specific projects which are supposed to produce tangible outputs. This process, along with weaknesses in performance reporting and lack of oversight of extra-budget resources has probably created a natural tendency for PSUs to increase their staff expenditure and other lavish expenses.  

19. Some more anecdotal evidence such as the difficulty of finding awardees for performance awards among PSUs point to some serious underperformance of many PSUs.

The question of the role of the state and its organisational forms  

20. Despite their common classification, the so-called “PSU sector” continues to cover a large variety of functions, management modes and organizational forms. Some have commercial functions that could be taken over by the private market in a market economy (for example, some milk producers, entertainment book publishers, and civil engineering organizations are found among PSUs). Some organizations have functions whose take-over by the market is more debatable (hospitals, universities etc.) or which raise questions about the capacity of government to regulate potential private monopolies. Finally, other functions that are more traditional public services carried out mostly by government organisations in OECD countries such as basic education, are also included among PSUs.  

21. Because of these differences in functions, the management modes of PSUs have evolved in a heterogeneous manner without an overall consideration of the sector and what management and funding mechanisms, or governance structure should apply to which function. Most importantly, they differ widely in their funding mechanisms—some having extensively developed external sources of funding—and in their operation through state planning.  

I.3. Current reform efforts  

22. Policy guidance on PSU reform, nationally and across sectors, is underdeveloped. The 10th five-year plan adopted by the National Peoples Congress in March 2001, required an acceleration of reform of those social services that are “suitable to be run as industries” as well as separation of PSUs from government and enterprises, and of for-profit organizations from non-profit organisations. However, there is no clear definition of what constitutes an enterprise and what it means to be “non-profit”.  

23. The recent “Decision on some issues concerning perfecting the socialist market economic systems” adopted by the 16th central committee of the CPC in October 2003, that is designed to provide overall guidelines for economic reform in the coming ten years, requires to “implement PSU reform continuously”, but specifies nothing beyond reform of personnel and compensation system.  

24. In practice, reform is being carried out at two different levels: at some sectoral levels, and in particular in science and technology sector; in some local governments (for example, the Zhaijiang
provincial government and the Nanjing municipal government); and in addition, overall managerial reforms are being carried out by the ministry of finance and the ministry of personnel.

25. At the sectoral and local levels, current reforms attempt to:
   i) Classify PSUs (typically divided into categories such as administrative and law enforcement units, public benefit units and business related units);
   ii) Commercialise some PSUs that are considered to be performing commercial activities into public enterprises or fully private companies; and,
   iii) Restructure the rest of PSUs (those considered to be public-benefit related) in terms of financing, personnel, and reduce their staff expenditure and staff numbers.

26. In some cases, non-profit organisations (NPOs) have been adopted as the preferred institutional form for reforming public benefit PSUs. Further studies at national level have also encouraged to transform many PSUs into non-profit organizations. The real status of NPOs, however, remains unclear. While the functions would require management not to pursue an overall profit making objective, the state would remain the owner of these NPOs, and would give them preferential tax treatment. This category should not be confused with non-governmental organisations (NGOs) that exist in OECD member countries. It seems that the more similar organisational form in OECD countries would be the government created foundations. However, those government created foundations have a much more limited role in OECD countries in terms of service delivery compared to what is being proposed by the Chinese government for its PSUs.

27. The question of changing the incentives of these PSUs is just starting to be addressed, and mostly by the ministries of finance and personnel. Ministry of finance is starting to think about how to best monitor the performance of PSUs. Personnel reform was launched in 2001, and aims at transforming guaranteed lifelong employment into fixed term contracts, and at giving more flexibility in compensation, hiring and firing. While the general lines of the reform are known, it is not likely to be implemented before a few years time. In addition, Government officials point to the need to decrease employment in PSUs. This has been in fact required for NPOs in the science and technology sectors since the 2000 reform. The actual staff cuts seems limited however, which is very understandable in view of the social consequences involved and the difficulties with pension liabilities.

I.4. Looking ahead

28. The problems of the PSU sector today differ according to the kinds of PSUs involved:

29. While some with functions of a clear commercial nature are being privatised—but not all-- others are also being transformed into SOEs often as a preliminary step towards privatization. The transformation of PSUs into private firms or SOEs needs to be completed. The first important challenge for the Chinese authorities is to define what can be run by the private sector and what should remain functions of government. This choice will have to be made according to the public or private good nature of the functions concerned, the capacity of the private sector to take over the functions carried out by PSUs, and, in some cases, the regulatory capacity of government.

30. The role of government should remain minimal for some of newly created companies when they provide commercial goods or services in a purely private good market that has an existing capacity. In other sectors, however, there will be a need to provide for good public regulation in order to maintain or create competition, as well as quality and cost standards when the market has a monopolistic tendency

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8 Cheng Siwei, China’s PSU reform: Choice of models and guidelines based on classifications.
(network industries) or/and when the nature of the goods and services provided qualify clearly as public services (e.g. in the health and education sectors).

31. It is likely that many PSUs will remain non-company government organisations. The question for the Chinese authorities remains how to best adapt organisational forms of the different PSUs involved, and best balance between the need for management freedom and accountability mechanisms for the use of resources. Although some of these entities might be able to raise some revenue, it is likely that many will remain mainly supported by state and local budgets for purposes of social and cross-regional equity, organisational accountability and government coherence.

II. The experience of OECD countries

II.1. A diversity of experiences

32. In respect of the organisations in OECD countries involved in sectors equivalent to those of PSUs, the most striking feature is the diversity of the scope of state intervention and organisational structures.

II.1.a. Diversity in the scope of government intervention in ownership and funding of public services in three of the most important sectors involved in PSU reform

33. If we look at the ownership of service delivery organisations and at their funding mechanisms in the three most important sectors concerned by PSUs—education, health and research—in OECD countries, government remains the most important player in the first two, and is of secondary importance to the business sector in the research area.

<table>
<thead>
<tr>
<th>Some data on OECD Governments’ role in sectors equivalent to PSUs’ (ownership and funding)</th>
</tr>
</thead>
</table>
| **a. The education sector**

Today, OECD countries spend 5.9% of their collective GDP on their educational institutions, and 13% of total public expenditure to education.

Schools, universities and other educational institutions are still mainly publicly funded, with over 88 percent of all funds for educational institutions coming directly from public sources—and 93% for primary, secondary and post-secondary non-tertiary levels of education. There are however, significant levels of private funding in some countries, most notably Australia (15%), Germany (20%), Korea (19%), and Mexico (14%).

On average across the OECD countries at the primary/secondary level, only 12% of the public funds designated for education institutions is spent in institutions that are privately managed (71% in the Netherlands, and 50% in Belgium).

Tertiary institutions tend to mobilize a much higher proportion of their funds from private sources than primary, secondary and post-secondary non-tertiary institutions. The private share ranges from less than 3% in Denmark, Finland and Greece, to 77% in Korea but includes private payments that are subsidized from public sources.

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This part of the report is drawn from *Education at a glance*, OECD, 2003
b. The health sector

Total expenditure on health vary between 14.6% of GDP in the United States and 5.6% in the Slovak Republic with 23 OECD countries out of 30 spending between 7% and 10% of their GDP on health. With the exception of the Netherlands and Poland, public expenditure on health vary between 5% and 8% of GDP.

The degree to which the delivery and financing of health care systems are publicly controlled or administered varies widely from one country to another. The OECD classifies them under one of the three approaches described below, but it is important to recognise that more than one of these approaches exist in most countries—even if one form is dominant.

Broadly speaking, there are three main structural types of insurance/financing and delivery systems:

1. The public-integrated model combines budget financing of health care provision with hospital providers that are part of the government sector. These systems, which merge the insurance and provision functions, are organised and operated like any government department. Staff is generally paid on salary (although, in some cases, doctors can have private patients as well and they are most often public sector employees). Ambulatory doctors and other health care professionals can be either public employees or private contractors to the health care authority, with a range of remuneration packages.

Broadly speaking, these systems exist in the Nordic countries, Australia (public hospitals), Italy, Greece, Portugal and, before the reforms of the early 1990s, the United Kingdom. New Zealand introduced a purchaser-provider split in the 1990s similar to developments in the United Kingdom, but it has since moved closer to an integrated model following reforms in 2000.

2. In the public-contract model, public payers contract with private health care providers. The payers can be either a state agency or social security funds. Single payer arrangements have a stronger position vis-à-vis providers (as in the public integrated model) and tend to have lower administrative costs than do multiple payer systems. In many public-contract systems, the private hospitals and clinics are run on a non-profit basis. Independent private contractors generally supply ambulatory care. In the past, payment of providers has been often on an ex-post basis for services provided although contract arrangements have been evolving.

Canada, most of the remaining Continental European countries, Japan, and now, the United Kingdom, and, to some extent, New Zealand, belong to the public contract category.

3. A private insurance/provider model uses private insurance combined with private (often for profit) providers. Insurance can be mandatory (Switzerland) or voluntary (United States). Payment methods have traditionally been activity based.

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10 This part is drawn from draft Health Care Systems: Lessons from the Reform Experience, OECD, 2004, and OECD Health Data 2004, OECD, 2004

11 In Health Care Systems: Lessons from the Reform Experience, 2004

12 For example, in the United States, the hospital system for veterans belongs to a public integrated model, and Medicare and Medicaid are a form of public contract model, with the remainder a private insurance/provider model. Other countries are equally complex. France has a social insurance system that finances most of health care, but the public hospital system is part of the government sector and as such is closer to a public integrated model. This sits alongside public contract arrangements with private clinics or hospitals (some of which are non-profit).
In 2001, OECD countries allocated about 2.3% of overall GDP to R&D. The business sector is the major source of financing of domestic R&D and accounts for more than 63% of funding in OECD countries in 2001 (73% in Japan, 68% in the United States and 56% in the European Union).

The business sector also performs most R&D. In 2001, R&D performed by the business sector reached close to 70% of total R&D in OECD countries.

The higher education sector performs about 17% of total domestic R&D in the OECD area. This percentage has increased steadily over the last decade in the European Union and the United States and has increased significantly in Japan.

Business funding for public research is small. However, for the receiving institutions, the inflow from business in some cases already presents a considerable part of their income (more than 10% in Belgium, Canada, Finland, France, Germany, Iceland, Ireland, Korea, the Netherlands, Norway, Poland, Slovak Republic, United Kingdom). An analysis of funding flows into the public sector has shown that financial support for public sector research from business has increased in many countries, in particular in the big “spender” countries.

When comparing the organisation of the sectors involved in PSU reform with those equivalent in OECD countries, it is clear that, depending on the functions and the country administrative culture, their functions could possibly be allocated to many types of organisations, either government-owned or not.

After determining what should remain public services or not (and either suppressing or privatising organisations providing services that do not qualify as public services), governments have a choice between owning public service delivery organisations or using private firms for the delivery of services.
ORGANISATIONAL FORMS ACROSS OECD COUNTRIES

II.1.b. The experience of OECD countries with the delivery of public services by government owned entities

36. In terms of the organisational form of public service delivery, one observes a similar range of organisational types of forms for government-owned entities across OECD countries:

- Ministries – directly controlled by the centre which undertake essential Government functions – diplomacy, finance etc.;
- Public Law Bodies – more arms length or indirectly controlled by Government undertaking a range of defined service delivery functions;
- Commercial Government Enterprises – state owned enterprises or virtual SOEs operating in commercial markets under private law with a profit objective and full or partial government ownership e.g. airlines, government electricity companies;
- Other Private law bodies - a range of organisations (trusts, foundation etc) established under Private Law but not with a for profit objective undertaking non commercial function.

37. Traditionally, in most OECD governments, core government is defined as the ministries and departments of the Executive, under the direct hierarchical control of a Minister and/or prime minister in parliamentary systems, or of the head of state in presidential systems. These direct accountability lines provide a simple and stable governance model in which policy making and the delivery of services fall under the responsibility of a government clearly accountable to parliament and ultimately to the people.
The same set of financial and management laws and reporting mechanisms generally applies to all of these bodies.

38. All countries, however, have always had some degree of managerial autonomy for government bodies that are separate from traditionally structured ministries or departments but remain core government entities. Many such bodies are long standing and have been created for a variety of reasons, both political and managerial. These bodies are removed from the direct and constant control of politicians, have different hierarchical structures from traditionally functioning ministries, and in some cases, have management autonomy or independence from political influence.

39. In the past two decades, OECD countries have significantly increased the number and scope of activity of these bodies at arm’s length from central ministries. In some cases bodies have been newly created with new governance structures, in other cases, long standing bodies have been given significantly more management autonomy.

40. In general, the rationale has been the need to have organisations better focus on performance. Arm’s length bodies have been a favoured form of implementing performance management as they have the potential to function better than core ministries under clear performance contracts with their parent ministries, benefit from a relaxation of their input controls, but have a clear accountability line to the minister, and in most cases, remain institutionally part of their parent ministries.

41. There is no universally accepted classification of arm’s length bodies. They differ widely in terms of organisation, legal status, and degree of management autonomy or political independence (see table 1). But basically governments have used three main methods to distance these bodies from core ministries:

- The first is a different governance structure and hierarchy from a traditional ministry.
- The second is a different control environment, in other words partial or complete exemption from management, financial, and personnel rules that usually apply to traditional ministries.
- And the third is a degree of management autonomy (including a separate financial administration).

42. These arm’s length bodies in central government now account for between 50% and 75% (or even more in very few cases) of public expenditure and public employment in some OECD countries. This new institutional environment has created new challenges for governments to maintain central direction and control.

43. Some of the functions carried out by PSUs are in fact carried out in some OECD countries by arm’s length bodies (many would be in the categories of public law administrations), such as hospitals, universities and research centres.
## Organisational classification of government bodies

<table>
<thead>
<tr>
<th>Legal separation from the state</th>
<th>Rules applying to the entity</th>
<th>Customers</th>
<th>Status of staff</th>
<th>Funding</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Traditional ministries</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Indivisible from the state</td>
<td>General rules applying to ministries/public law</td>
<td>Minister</td>
<td>Civil servants</td>
<td>Tax funded</td>
</tr>
<tr>
<td><strong>Departmental agencies</strong></td>
<td>Tax funded (possibility of small fees)</td>
<td>General rules applying to ministries, Relaxation of some input controls</td>
<td>Mixture of public/private customers</td>
<td>Civil servants</td>
</tr>
<tr>
<td><strong>Public law administrations</strong></td>
<td>Partially or fully legally separate from the state</td>
<td>General rules applying to government entities/public law, Relaxation of some input and process control rules</td>
<td>Mixture of public and private customers</td>
<td>Partly public servants</td>
</tr>
<tr>
<td><strong>Indirectly controlled bodies</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Government enterprises:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Commercial government enterprises (government companies)</td>
<td>Legally separate entities from the state</td>
<td>Private law bodies</td>
<td>Private customers</td>
<td>Private law employments (sometimes some specific status)</td>
</tr>
<tr>
<td>2. Non-commercial other private law body (quasi corporations)</td>
<td>Id.</td>
<td>Id.</td>
<td>Id.</td>
<td></td>
</tr>
</tbody>
</table>
II.1.c. The experience of OECD countries with the delivery of public services by private sector organisations

44. In addition to the use of government organisations, the governments of OECD countries have experimented with the greater use of private organisations to play a greater role in delivering publicly-funded services.

i.) Public-private partnerships

45. PPPs usually involve the financing and/or operation and management of public infrastructure projects by the private sector. They have mainly taken place in the fields of transport infrastructure and, to a lesser extent, for energy projects and in the health and education sectors. The use of PPPs remains limited: in the United Kingdom, the country which has made the most use of PPPs, about one-tenth of its total capital investments in public services in 2003-2004 are through PPPs, and this has been relatively consistent over time. PPPs have had mixed results, the gains in operational efficiency being sometimes undermined by the difficulty of contract management, the transaction costs involved in preparing and negotiating the project, and the difficulty of maintaining the balance of risk transfers between government and the private sector. In addition, from a public finance point of view, PPPs can only be justified if the transfer of risks and the efficiency gains outweigh the higher cost of capital of private sector financing.

ii.) Outsourcing

46. Outsourcing is the practice whereby governments contract with private sector providers for the provision of services to government ministries and agencies, or directly to citizens on behalf of the government. Partial data show a significant increase of outsourcing in member countries in the last 15 years. The first activities that have been contracted out include “blue collar” support services such as cleaning, security and canteen services; maintenance and printing services, which are not considered as critical to the mission of the agency. The second group of activities that have been outsourced are high-value professional service, including “back office” activities (information technology, banking and financial services). This is where the greatest growth has occurred in recent years but country variations are more pronounced. Outsourcing of mainline functions remains limited but has made important in-roads in some countries (employment placement services, child welfare services, long term care institutions, research and development).

47. While experience in OECD countries shows that when successful, contracting out can increase efficiency significantly, it also raises significant questions about the contracting capacity of the contractor (most importantly in terms of measuring performance of the service provided).

iii.) Regulation

48. When governments decide that a public service with monopolistic tendencies such as in the network industries (electricity distribution, telecommunications, water distribution, etc.) can be carried out by privately-owned companies (whether as sole competitors or including publicly owned competitors), regulation is required to maintain competition, and different standards of public services. Regulation has to do with business entry, prices, quality of goods and services, protection of the environment, work safety and health issues.

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14 For further details, pls refer to the following OECD/GOV documents: Public sector modernisation: the use of market-type mechanisms in the provision of government services, GOV/PGC(2004)19, OECD, 2004  
15 id.
49. With the marketisation and privatisation of former state-owned enterprises and the establishment of competition in formerly monopoly based industries with network characteristics such as energy and telecoms, independent regulators have mushroomed in OECD countries. Although widely used, these new institutions often raise political challenges and involve significant design issues related to their independence, accountability, performance, and the quality of their regulatory activities.

iv.) Quasi-government

50. In all OECD jurisdictions there is a range of bodies that are usually private law bodies with private owners, with a governance board with some government appointees, they are partially financed on government grants and have no government controls on staff or others. In this category we find some of the government-created foundations for example.

51. There are significant governance risks for government with these privately-owned bodies, particularly when government appointed members sit on the board. Even though they are outside the consolidated general government, the line between public and private sector is blurred. In some countries, the courts have sometimes found the government responsible for the actions of bodies that the government did not own (which is why they are outside the financial reporting entity) but were deemed to control.

52. Thus, there are a range of legal bodies established by statute but not owned or fully controlled by government and which are charged, in part, with performing some public policy functions. The government has an interest in how the body performs some of its functions and a contingent liability if it is deemed to have control.

53. This risk suggests the need to use an extreme caution in establishing quasi-government instrumentalities.
II.2. General lessons learnt from OECD countries

54. Experience from OECD and transitional economies suggests that choosing an appropriate organisational form requires a lot of care in terms of choice of function for different organisational forms, and in terms of capacities. Once the form has been chosen, many other conditions have to be fulfilled for the new organisational form to result in the expected positive effects. Experience in OECD countries and transitional economies shows that when these conditions are not fulfilled, organisational reform can be counterproductive and result in losses that can have long term effects on capacity to deliver services, and on trust, and may possibly exacerbate corruption.

II.2.a. Identify the public interest and divest from activities where there is no clear public interest

55. Across all OECD countries there has been a widespread trend towards for governments to pull back the delivery of commercial services – initially by placing commercial activities with commercial government organisation (state owned enterprises) and subsequently with privatisations. OECD governments have redefined some of the basic rules for government involvement in an activity. Over the last two decades, privatisation proceeds in OECD countries have been in excess of ¾ of a trillion dollars, slowing down since 2000. In general, two types of assets have been privatised: i) assets in the commercial and competitive sectors which could be owned and provided for by the private market without government involvement (banking, manufacturing); ii) assets in the commercial sectors that have remained public services or monopolistic sectors, but provided by the private market – either in highly regulated sectors or through contracting arrangements (network industries)

56. There is little doubt that there are some PSUs whose functions should require little or no government involvement because these entities provide goods and services in the commercial and fully competitive sector. In this context, the Chinese authorities are continuing to privatize or close down these entities.

57. All countries bear some exceptions in this sector that are justified by historical, sociological or political reasons.

58. The privatization process requires some important preconditions for its successful implementation and to avoid increasing corruption, that have to do with financial sector reform, having hard budget constraints and the organisation of competition and wide ranging divestment.

II.2.b. The right organisational forms for the delivery of activities where there is a public interest

59. Once the areas where the government should retain capacity have been identified, there are different organisational forms for the delivery of public services that can be chosen. The guiding principles for the choice are:

i.) Form follows function: The chosen organisational form depends on the functions performed (policy making/service delivery, commercial/non commercial, focused and measurable services/unfocused and non-measurable services are probably the most important splits). In general, two principles apply: i) commercial services tend to be outsourced and delivered by privately-owned organisations (or, as a transition, by government companies); ii) arm’s length organisations should be used only for functions that aim at providing one or very few interrelated specialised services, that are focused and measurable, so that the use of resources remains highly controlled and performance measured.

ii.) Maintain government capacity: Whether the organisational form chosen means delivery by government or non-government actors, or arm’s length delivery, national or local government entities which are ultimately responsible for service delivery need to retain capacity in the sector so as to control
performance and the use of government resources. Governments need to invest in their capacity to manage contractual relationships (this includes negotiating, drafting, controlling and directing contracts) and monitor the performance of organisations. This is recognised as a major challenge in OECD member countries.

iii.) **Avoid organizational zoo:** Organizational forms should be thought through within a coherent framework of organisational forms, with a rather limited number of organisational forms. There should be a specific sectoral and cross-regional coherence, for policies to remain coherent and for accountability and control to be possible.

iv.) **Restructuring adds costs:** The benefits of organizational reform should be weighed against the disruption costs of organisational reform, and the costs in terms of added staff insecurity, and possible loss of institutional memory.

v.) The default organisational category is the classic vertically-integrated ministry: When in doubt about whether the preconditions for specific organisational changes are fulfilled, governments are advised to choose what has proved to be the safest organisational form for public service delivery in the long run, i.e. the classic hierarchical ministry.

The following develops the specific requirements for the various chosen organisational forms

i.) **Delivery by semi-autonomous government bodies**

60. The risks of semi-autonomous government are well-known to OECD countries and transition economies. They lie mainly in a weak accountability structure that may result in inefficiency, capture, lack of government and policy coherence and possibly patronage and corruption. The conditions of success of arm’s length government have to do with the functions carried out, the general governance framework, the accountability mechanisms and the capacity of reporting entities to manage organisations by contract. These would include, in particular:

1.) A sound legal and institutional framework that limits the number of types of arm’s length bodies, give them a clear legal basis and justify any exceptions to the stated rules. This legal and institutional framework should take into account the following:16

- grouping organisations into classes, establishing strict principles for the creation and removal of new entities
- assigning specific governance responsibilities
- providing a generic law for organisations
- establishing policy agreements with the different bodies
- establishing principles of public finance for these bodies
- specifying rules under which staff function
- specifying the external reporting and auditing procedures as well as the planning and control cycle,
- assigning individual responsibilities

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16 Drawn from “Distributed Public Governance: principles for Control and Accountability of Agencies, Authorities and other Government Bodies”, by Rob Laking, in Distributed Public Governance, OECD, 2002
• establishing sound procedures for accounting on the use of public resources, the results achieved and good governance standards; for accounting to and consulting with stakeholders
• establishing standards of behaviour
• establishing control and audit procedures and principles

2.) A well-thought through structure for individual institutions is also important, including a gradual move to arm’s length systems. Not all bodies will be ready at the same time to function at arm’s length from government, not least because governments need to make sure they have enough managers available to work at arm’s length in a performance-based environment, and reporting entities need to be able to function well in a contract-based environment.

3.) Organisation of the necessary constant interface between arm’s length organisations and central (not parent necessarily) ministries.

4.) Accountability of and reporting by delegated managers, and need for a strong oversight of bodies, including by parliament.

5.) Sufficient time to move to arm’s length status. It takes months, and often years, to transform part of a traditional ministry hierarchy into an arm’s length body that functions well, and for the supervisory ministry to be able to steer it well. The process of getting things right cannot be entirely driven by the top but depends on co-operation and learning from both parties.

ii.) Delivery by private firms\(^\text{17}\) and non-government organisations

61. Privately-owned firms can only deliver public services that have easily identifiable and measurable products of a commercial nature.

62. The main risks of delivery of public services by private firms lie in the danger of creating a private monopoly that is too costly to the public, and does not provide services of the quality standards required by government.

63. When contracting out or establishing public-private partnerships, Governments are strongly encouraged to invest in their contract management capacity, not to underestimate the sectoral capacity they need to monitor the performance of delivery by the privately-owned entity, and to continuously put pressures on private providers. Governments need to ensure that they continue to have the operational knowledge to make good policy and choose—and alter—service delivery in a dispersed and networked environment. Specific conditions apply respectively to public private partnerships and contracting out that cannot be developed fully in this paper.

64. When the services are provided by privately owned organisations that fall under government regulation for a public service, the issue of the quality of regulation becomes crucial to the delivery of services. In designing an overall reform strategy, a lot of attention has to be paid to regulating entry, prices, quality, and the availability of subsidies. The design of the institutions that carry out regulation is crucial in order for regulation to be predictable and transparent.

\(^\text{17}\) For further details, please refer to the following OECD/GOV documents: Public sector modernisation: the use of market-type mechanisms in the provision of government services, GOV/PGC(2004)19, OECD, 2004
65. Some countries with a long civic tradition see private non for profit organisations delivering publicly funded services particularly in health and education. These are country specific exemptions to a general rule.

66. Public service delivery by non-government organisations or private firms is not dominant in OECD countries. In addition to the conditions described above for private firms, Government needs to ensure that the NGO, associations, or foundations that will provide services have a good governance structure to prevent capture by specific interests. It is also crucial that there be a clear distinction between the role of government and the role of the organisation chosen for delivery of a specific service.

III. Key future reform challenges for China

67. The Chinese government considers that the PSUs have three main problems: they are too costly, underperforming and too heterogeneous. On the basis of OECD member countries experience, it is suggested that the Chinese government should address these problems with the following approaches:

III.1. Clarifying the problems and challenges at stake.

68. The problems at stake in the reform of PSUs are of various nature and should be considered separately, but they should be coherent among themselves. In fact, behind a reform of organisational structures, there are four kinds of reforms the Chinese authorities are trying to implement, that have different types of issues at stake:

   i) Redefining the boundaries of state intervention (what is a public service?) will require a reflection on the missions of the state, existing capacity in private market, and on ways to create and reinforce this capacity.

   ii) Determining what public service delivery organisation the government should own (public or private?): Deciding on whether public or private organisations should deliver public services will not automatically improve service delivery, decrease costs, or help raise new revenues for public services. The success of contracting out to the private sector or regulating requires significant new capacity for central government. In its absence, private delivery of public services might bear opposite results.

   iii) Diversifying the sources of revenues for public services (fees to the public): This touches upon a different set of issues that have to do with the costs of public services, the capacity of citizens to directly take over some of the funding of public services, and equity.

   iv) Increasing the incentives for good performance of public services units (and then what accountability structure?): establishing a performance-based organisation requires to establish some performance based financial and human resources management. It is how resources allocation are made and accountability mechanisms for good performance are established that improve incentives for good performance. Organisational form can only embody this new priority and new management system but does not create incentives per se. A robust institutional framework is key to ensuring performance but not sufficient to ensure it.

III.2. Balancing coherence and diversity

69. Considering the diversity of PSUs in terms of sectors, organisational forms, reporting structures and the different levels of reporting (national, provincial, municipal), it seems crucial that an overall governance framework for service delivery be thought through and a general guideline produced on how to analyse the PSU reform. This framework would give some coherence to a reform that touches upon crucial issues such as the role of the state in education and health and its modes of service delivery.
Coherence within sectors and across levels of government is crucial for organisational clarity, policy coherence, accountability, and equity. As such, it is very important that a robust institutional framework is put in place and equal standards of service delivery be established for organisations across the country.

This framework, however, should allow for a large flexibility of choice of organisational forms according to the sectors.

### III.3. Applying appropriate reform levers

Choosing different organisational forms for PSUs will not necessarily solve the issues of their funding and the lack of performance incentives for those organisations.

At present, PSUs are allowed to keep unspent revenue in their budget, one of their main incentives for good performance. However, in a weak performance monitoring environment, it is unlikely that this incentive helps organisations perform better. The lack of autonomy of PSUs is not the core problem of their lack of incentives to perform.

Reflecting on the lack of incentives will require reviewing the following levers:

1. The central capacity to control performance and contract PSUs on performance.
2. Human resources management, and in particular the management of senior management; and,
3. The management of financial resources and in particular, the budget allocation mechanisms.

Finding additional resources for funding PSUs will inevitably require a reform of the tax system in China which would help China raise more revenue. Indeed, it seems that it would be unwise to promote a model of general public service delivery —especially in the health and education sectors-- where each organisation would generate a significant part of its own revenues from fees and other revenues drawn from citizens or firms. In addition to widening disparities in the provision of public services across regions and socio-economic backgrounds of citizens, such a policy would make the implementation of government-wide policies much more difficult.

### III.4. Considering wider issues of governmental capacity

Today’s problems in the field of PSUs reflect larger problems of government capacity in China.

Granting additional autonomy will require stronger capacity in the centre (either at national or local government levels) to design government-wide policies, govern more autonomous government entities by contract on performance, control performance and the use of resources. It will also require additional capacity in terms of leadership of these more autonomous entities.

### Conclusions

The experience of OECD countries leads us to recommend against any assumption that PSUs are a “sector” with common characteristics — potentially these functions might be assigned across the full range of organisational possibilities.

While there is some commonality across OECD countries in terms of what is “public” and what is “private”, at the margins this cannot be determined outside of the particular country context. Decisions by the Government of China need to take account of national and sectoral priorities, risks, private sector capacity and the quality of the wider institutions governing both public and private institutions.
The experience of many OECD countries shows that reforming government organisational forms requires first to better define the respective responsibilities of the public and private sectors in the provision and delivery of services. There are some sectors which are easier to classify than others: the banking, industry and agriculture sectors are clearly areas in which government ownership of the delivery organizations should remain limited. At the other end, services that are sovereignty functions of the state (e.g. diplomacy) or services that imply making administrative decisions (e.g. tax collection) are clearly functions of the state that require government to retain overall responsibility for the provision and delivery of services.

Sectors such as infrastructure, education, health and research require a more careful consideration and often result in a more mixed picture. In all countries, the government retains an important role, in both the overall regulation of the sectors and in many cases in the direct provision of services—whether they are delivered by government owned organisations or private entities contracted out by government entities. The delivery of public services by private sector organisations requires an important increased capacity for regulating the sectors, and existing capacity in the private sector to take over.

In some areas, while the ultimate desirable form may be clear, there will be serious problems of transition, including capacity of the private sector to take over, and for reporting ministries, to steer, regulate and control.

For the provision of public services, government has to retain an important policy making and enforcement capacity, as well as important coordination mechanisms. It is clear from the experience of OECD countries that as much attention should be given to strengthening parent ministries capacity to regulate or control and steer, as to the design of new organisations for the delivery of goods and services.

Diversity of organisational form in the public sector—especially in an immature market framework—can pose serious risks to the collective interest. The management of this risk can be facilitated by some umbrella legislation defining the authority and control of different kinds of organisations.

Once the clarification between the responsibilities of the public and private sectors in the provision of public goods and services has been done, it is clear that there can be only a limited number of organisational structures and governance relationships for the provision and delivery of services for which government remains responsible.

The government can have three different functions:

- The government can be the regulator of service provision and delivery by the private sector. Apart from general market supervision by anti-trust authorities, this regards particularly sectors where forms of natural monopoly or undesirable forms of market power tend to emerge: telecommunications, the banking sector, the insurance sector, electricity, railways etc.
- The government can be the contractor of services to private entities, especially for certain commercial goods with a clear public service function under certain conditions
- Government organisations can remain directly responsible for the delivery of services. In this case, government may define an overall framework for the delivery of services and define what services can be provided at arm’s length and what general relationships should be built for ensuring the good governance of the overall system. The fewer categories, and the more uniform the rules applying to them, the more legible the public governance system is to politicians, civil servants and citizens alike. Having too many forms of government organisations and too many organisations increases the risk that they will not work together on
important common objectives, or that complex problems of public policy “fall between the cracks” of organisations responsibilities.

87. While the relative “autonomy” of some government entities may be desirable, changes in organisational form should aim at preserving good governance and in particular accountability for the use of resources.

88. Establishing entities at arm’s length from reporting entities respond to two “good governance” reasons: to improve the performance of the public sector by bringing decision making closer to the point of delivery and to make public decision making more credible by separating it from direct political intervention.

89. Arm’s length government, however, cannot solve the problems of a generally ill-functioning government. Experience from transition economies gives mixed messages about establishing new organisations to evade general problems of governance in the public sector, as even autonomous bodies need to be strongly coordinated and overseen by parent ministries. Also, it is impossible to create a lasting performance culture in an environment of under-performing government.

90. It is therefore crucial that when establishing organisations at arm’s length from government, the whole governance framework of government should be considered, especially the capacity for central government entities to steer, control, and conduct a dialogue with the management of these bodies especially on performance issues, and the general capacity of those organisations leadership to manage the newly created organisations. Formally, this means that a particular attention should be given to the supervision, and ultimately the ministerial right to intervene, including through the following devices:

   (1) the general arrangements for a planning agreement, regular updates, between the parent ministry and the agency, covering mission, specific performance targets and budgets, and covering reporting arrangements;
   (2) powers for the minister or other political authority to give policy or operational directives transparently (by public notice or tabling in the legislature)
   (3) Emergency powers – for the political executive to intervene and dismiss the governing board or the chief executive if and when there is a failure of management.

91. This organisational change also requires a thorough reflection on financial and people management, as well as on the means to maintain accountability to parent ministries, by stressing:

   (1) the rules that apply to the appointment and dismissal of top management and governing boards (when they exist)
   (2) the detailed definition of relaxed controls on arm’s length bodies
   (3) the emphasis on results management. In OECD member countries, it has taken years for organisations to learn how to specify results and how to supplement attenuated management through reports with other forms of surveillance. It is indeed difficult to define measures which properly represent desired results, are comprehensive in their coverage and reasonably parsimonious in number.
   (4) the individual accountability of managers for the performance of the organisation—and, related to this—how to create a general culture of performance (through mechanisms of staff accountability for results)
   (5) getting the parenting right: the framework law establishing the arm’s length body needs to define a clear formal line of accountability from the agency to the political executive. A parent
ministry should be clearly responsible for transmitting policy requirements and monitoring implementation. But even with the right formal framework, the problem is to get the supervision right. This requires that the parent ministry has the necessary competence to administer a performance management system which requires capabilities akin to the operational management skills of the body itself.

(6) safeguarding accountability for resources: The risks to provide financial and management autonomy are important: if arm’s length bodies are able to raise their own resources, they can reduce the ability of government to control its overall spending and impact on the economy, and they can disguise inefficiencies by extracting more revenues from their clients. When they are permitted to do their own borrowings or enter into leases, they may create contingent liabilities for government. Managerial autonomy and freedom from general rules regarding hiring and remuneration for staff can compete away skilled staff from core government and also increase opportunity for corruption and patronage.

92. Increasing managerial flexibility over budgets and staff does not mean abrogating central control: it means substituting a form of governance based on detailed external rules and individual transactions-based approvals, to one based on strong external budget disciplines, monitoring, reporting and audit; and assurance through good systems of internal controls and internal audit. No government should delegate without being satisfied that it has both the internal and external framework for effective steering and control in place.

93. When the conditions for a successful autonomy of organisations are not met, government authorities should not hesitate to draw some organisations back into traditional vertical ministerial hierarchy. Some PSUs could then become bureaus or field units within integrated departments. While this might still be feasible in China right now, OECD countries have usually found it very difficult to draw an autonomous body back into traditional ministerial hierarchies. This is another reason for using caution in developing semi-autonomous government bodies for service delivery.

94. PSU reform will not exempt Chinese government from a reform of the budgeting and tax system. Giving PSUs additional autonomy in terms of raising revenues without improving the overall tax system is not sustainable. Fees and revenues raised from the public will be hidden taxes which will result in significant increased social and regional inequities. In addition, an improved budget allocation system should help better decide on resource allocation to match policy priorities. The reform of PSUs could be an opportunity to contribute to the reform of the budgeting system.