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CHINA GOVERNANCE PROJECT

DRAFT SYNTHESIS

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Introduction

Governance matters

1. To ensure the sustainability of the development path taken, several challenges ahead need to be addressed. The third plenary meeting of the 16th CCP conference which took place in October 2003 is a turning point in Chinese public policy. At this occasion, leaders exposed the need to shift to a New Development Strategy. Quoting Hu Jintao: "China needs the development which balances development between urban and rural areas, between the regions, between social and economic aspects, between human and nature, and between domestic and international policy development". In addition, potential sources of economic slowdown (obstacles to efficient allocation of resources, ensure technological upgrading, fault lines of the financial sector etc.) need to be addressed. There are growing inequalities among provinces, between rural and urban areas and among households. Finally, the increasing demand for social services needs to be addressed.

2. How China is going to address these challenges, and thereby ensure the next stage of economic development and the social and environmental sustainability of this development path, largely depends on its future governance structure. The tensions between an increasingly liberalised economy and the partially reformed institutions of an authoritarian polity have become increasingly severe. The WTO study concluded on the need to for a comprehensive approach to economic reform, a better implementation of policies and better coordination of government departments. In other terms, these conclusions pointed out to the need to improve China's governance.

3. Good governance is crucial to switch from a development strategy focused on the rate of GDP growth to a more balanced development strategy. “Governance” refers to how public policy-making is arranged and how public policies are implemented. Governance is "good" when these two processes (policy-making and implementation) ensure that constitutional or collective values are protected overtime. Public administration is not only important to public governance, it is a constituent pillar.

This book

4. This book provides a picture of governance in China and its recent evolution. Its purpose is to encourage Chinese policy makers to address critical governance issues that affect China’s social and economic development and its relationship with the outside world. It is intended to provide Chinese policy makers with policy advice and support, rooted in the practical experience of member countries. It also provides OECD members with a better understanding of the complex governance challenges facing China as it moves further in its transition to a market based economy.

5. Possible solutions to these governance challenges are also explored in this book, borrowing from the experience of OECD member countries. It is certain that the notion and practice of governance is intimately linked to that of the political system. Even if the Chinese political system does not share some of the important characteristics of democratic pluralism common to OECD Member countries, the experience of their governments is a crucial source of information for Chinese reformers. Indeed, one of the major questions underpinning the current governance challenges is the broad question of the role of the State in a market economy in interaction with private actors. Moreover, collective action, its forms and its reforms, pose comparable problems around the world.

6. The book contains two types of chapters, which reflect different approaches: "whole-of-government issues" refer to issues that are common across the government, i.e. related to the public administration or the overall regulatory framework for instance; "sectoral issues" refer to design and implementation issues specific to particular social and economic policies.
Box 1 - OECD Good Governance Principles

The OECD Public Management Committee has adopted a set of principles that decompose the idea of good governance into six elements:

- Rule of Law. All actions and decisions should be applied equally and only based on the application of law.
- Accountability. All government actions, decisions and decision-making processes need to open to scrutiny by parliament, civil society and the public -- and in some cases supra-national bodies.
- Transparency. Government needs to be able and willing, through the provisions of information and explanation to show the extent to which its actions and decisions are consistent with clearly-defined and agreed objectives based on sound analysis;
- Efficiency and Effectiveness. Governments need to produce high quality cost-effective public outputs to citizens, and monitor and evaluate their performance;
- Responsiveness. Government needs the capacity and flexibility to respond rapidly to changes, consult widely and is willing to re-examine critically the role of government;
- Forward-Vision. Government is able to anticipate future problems and issues based on current data and trends and develop policies that take into account future costs and anticipated changes (e.g. demographic, economic, environmental, et cetera).

The above principles take for granted the basic values shared by all OECD members, i.e. an open market economy and democratic pluralism.

This Synthesis

7. The present synthesis is an attempt to bring together the main issues and conclusions raised in the 18 chapters of this report.

8. It is structure in five parts. A first part gives an overview of the Chinese State and develops recent evolutions that have affected the policy making process. Part II and III address respectively public finance issues and organisational and management issues. A fourth part takes stock of the progress made in the institutional infrastructure for market forces. A last part discusses the problems of enforcement and of corruption. Public governance issues cannot be nicely organised in a linear framework of analysis. It is unavoidable to have cross-linkages and overlap of issues.

I - Policy Making

9. Overall progress has been made in the structures and practices under-pinning policy-making. Objectives are now set in clearer terms, referring to targets and indicators. The policy-making process has become more open to voices from local governments. Also, the policy-making process has become more open to public participation, through consultative meetings and the discussion of draft plans with stakeholders. Weaknesses of course remain. For instance, there is a lack of mechanisms to assess budgetary cost, economic impact, social and environmental impact, and the efficiency and practicability in implementation when preparing policy options.

10. It was out of the scope of the project, and therefore of its synthesis, to go into a thorough analysis of the policy-making system in China. This part will thus not get into a systematic analysis of the policy-making process. Rather, a first sub-part gives landmarks on the Chinese State and its functioning. A second
sub-part looks at more closely the Party – Executive interface and the policy vehicles. It then analyses the important evolution towards the rule by law and the rule of law. A last sub-part looks at three levers that contribute to the quality of the policy making process: access to information, statistics and public participation.

I.1 - Overview of the Chinese State

11. The current Chinese political regime was founded in 1945 after the victory of the Communist Party of China (CPC) over the Nationalist Party or Guo Min Dang. Today, China continues to be characterised by the pre-eminence of the CPC, which governs all central and local level State organs. Chart 1\(^1\) shows the architecture of the main non-Party State organs.

12. With about 67 million members, the Communist Party of China is the largest political Party in the world. The broad lines of its formal organisation are set in the Constitution of the Communist Party of China. The Party exercises political, ideological and organizational leadership and has organisations at the five territorial levels.

13. In contrast to the Soviet Union and most other soviet-type political systems, the CPC bureaucracy does not duplicate state administrations. The Central Committee of the Party, which contains the leading figures of the Party, State and army, has direct control of only a few departments, such as the Organisation Department which oversees the recruitment and career of the highest officials in the Party.

14. The political system organises the territory in five levels. Directly under the central level are the provinces (sheng) and the autonomous regions and four municipalities. China counts today 31 provinces, the average population of a province is 45.3 million. Under the provincial level, are prefectures and cities divided into districts; then counties (xian) and autonomous counties; and finally townships, cities without districts, districts under the jurisdiction of a city.

15. The National People’s Congress (NPC) is China’s parliament. According to the Constitution, the National People’s Congress is the “highest organ of state power”. In reality, however, it has in practice less power than the State Council and several communist party organs. The NPC and its permanent Standing Committee exercise the power of legislation, decision, supervision, election, appointment and dismissal.

16. The court system consists of the Supreme People’s Court, local people’s courts and special people’s courts such as the military court. The State prosecution system consists of the Supreme People’s Procuratorate, local people’s procuratorates and special people’s procuratorates such as the military procuratorate.

17. The President is the head of the State. He promulgates laws, appoints the premier, vice-premiers, state councillors, ministers of various ministries and state commissions, the auditor general, according to decisions of the NPC and its standing committee.

18. The State administrative system is composed of ministries and commissions. Each ministry supervises one sector. Commissions set policies on matters which require horizontal co-ordination of various substantive areas and generally out rank ministries. Ministries and Commissions are not the only bodies directly under State Council authority. Also reporting to it are bureaus or administrations, some of which are as important as ministries (e.g. State Administration of Taxation).

\(^{1}\) Borrowed from www.china.org
19. State administration is governed by the State Council, the chief administrative body of the People's Republic of China which supervises ministries, commissions and bureaus. It is chaired by the Premier and contains the heads of each governmental department and agency. There are about 50 members in the Council. The actual executive is the Standing Committee of the State Council, composed, at present, of the Premier and four Vice-Premiers, five State Counsellors and a secretary-general. This restricted cabinet meets twice a week and takes all important governmental decisions.

20. Xitongs are groupings of functionally related Party, government and/or military bureaucracies. These are headed by corresponding "leading groups" (lingdaoxiaozu). These leading groups create bridges between leaders at the apex of the political system and thus contribute to the coherence and coordination of policy decisions. The strengthening and formalization of the role of different leading groups has been critical in the development of more coherent policies and in expediting decision-making (see for instance Chapters 8 and 16). The evolution of groupings, their composition and their relative influence reflect the leaders' priorities and strategies.
I.2 - Policy Documents and the Party Executive Interface

21. Short-term (one year) and long-term (five to twenty years) policy documents set orientations for the Party, the National People’s Congresses and the executive administrations at central and local levels. The Party documents, the Reports of the Central Committee to the National Congress of the Communist Party and the Communiqués and Decisions of the Plenums of the Party Central Committee, define the general policy framework for the country. The five-year plans for national economic and social development, the five-year legislative plan, the national economic and social annual plans, the budgets and yearly legislative programmes are defined in reference to these broad Party frameworks. This contrasts with some countries of the former Soviet Union where, when moving away from centralised economic planning, public officials and leaders went too far and overlooked the need to set a general policy framework with different time perspectives.

22. While the budget still does not have the same stature as it does in OECD Member countries, its importance has been increasing significantly and rapidly. In OECD Member countries, it is through the budget that the government’s policy objectives are reconciled and implemented in concrete terms.

23. The Party, as the locus of power, is meant to be the spine of the executive. At the central level, the party / government distinction erodes at the top of the political system, in particular in the leading groups.
Below these, the pre-eminence of the Party over the executive takes different forms. First, at the different territorial levels, access to the positions of power in the government is very much determined by the positioning of individuals within the Party. Second, at the centre, the Party Central Committee and its related bodies are where important decisions are taken. Similarly, for lower territorial levels, the Party Committee is the leading body, to which the government is subordinate. Third, "Party Core Groups" were initially set up to have a separate forum in which the top party members working in government commissions and ministries could gather, separately from non-party individuals in positions of authority. Fourth, the Party controls the number of established posts in all Party or government administrative organs, public services units or working units. This bianzhi system allows the Party, through the Commission for Public Sector Reform, to exercise control over the state administrative apparatus, from the highest state office to the local primary school. Fifth, all important non-Party organisations at the district level and above host Party groups.

Nevertheless, in practice, the ascendancy of the Party over the executive is not invariably strong in all situations. Internal documents report that, in some localities, local governments and people’s congresses do not always follow the Party committee. Tensions occasionally appear between administrations and the Party organs.

The redefinition of Party government relationship is an important policy issue in China today. If a true separation from these two institutions would require dramatic political changes that are unlikely in the near future, reflections take place on how to better organise the division of labour of the two bodies. A pilot project reforming the Shenzhen municipal government experiments a more systematised relationship between the Party and the government. This reform is more an administrative than political, as its main achievement will be to reorganise administrative bureaus separating decision-making, implementation and control. Yet it contributes to limit the role of the Party to "drawing up the overall economic development strategy for an area and to setting some other important policies", forbidding it to "go over the heads of the government to get involved in the work of the government".

I.3 - Towards Rule by Law and Rule of Law

A fundamental evolution has been the official commitment to "ruling the state by law, constructing a socialist country based on the rule of law". The use of the term "rule by law" refers to a system in which government policies are implemented by enacting formal legal rules. "Rule of law" refers to a system, in which state power itself is constrained by law.

But also of the judiciary and legislature.


The Chinese name of this commission is zhongyang jigou bianzhi weiyuanhui, a direct translation of which would be: central commission for establishment and structure.

These can also be called party committees, but should not be confused with the party committee of the corresponding territorial level.


Quotations from J.P. Cabestan’s text presented to the brainstorming.
a) Rule by Law and Regulatory Capacity

27. Since 1978, the rule by law has been progressively strengthened. Before the beginning of the reforms, orders issued by the CPC and different parts of the government were the only basis for administering state affairs. In the past two decades, there has been a progressive shift from governing by executive orders to governing by law.

28. The 2000 Legislation Law has contributed both to making the law-making process more standardized, transparent and coherent, and to clarifying the role of the NPC and of the State Council in the legislative process.

29. China has made very rapid progress in equipping itself with new regulatory sets. In particular, progress has been considerable, leading to regulatory framework of quality comparable to international standard, in areas that did not pertain before to the field of public action. China has a relatively good regulatory framework for instance on environment, with at its basis the Environmental Protection Law, and more then 2000 laws issued in the area of environmental protection. This is also the case for intellectual property rights, anti-corruption, environment, financial institutions and budgetary rules. WTO requirements have been an important driver behind improvements in regulatory quality in these areas.

30. There is of course margin for improvement, as highlighted in the different chapters.

31. A first type of problem encountered is the lack or quality of secondary level regulations. For instance, the general requirements found in the laws on environmental protection are not supported by corresponding secondary level regulations which would define responsibilities of various parties and detailed implementation provisions. So when firms or individuals violate the rules or regulations, the environmental protection departments cannot enforce the law effectively due to lack of the legal basis. Similarly, the foreign investor rights and responsibilities in areas such as taxation and employee benefits are not clearly defined.

32. Problems of horizontal and vertical regulatory coherence are also highlighted in the report. For instance, still in the environment policy field, some interlinked instruments, such as permits and pollution levies are not coherent; this makes the system difficult to administer. Even if these are normally based on national legislations and central government policies, IPR local regulations are sometimes in conflict with central government regulations. The National People's Congress and the State Council should normally play a supervising role, but the large volume of sub-national legislation makes this task difficult to achieve.

33. Commentators sometimes point out to the fact that the NPC tends to draft laws broadly, leaving considerably room for interpretation by those charged with executing and enforcing them. This contributes to sharpen the problem of regulatory coherence, at the national level and across levels of government, and the coherence among regulations, in particular with the Constitution.

34. In areas which were regulated previously through the planning system, things have been different. The problems described above may well also apply in these sectors, but the overall environment usually keep traces of the past planned regime, resulting often in an overly-complex regulatory framework. Chapters 8 and 16 for instance show it is the case for statistics and agricultural policies. The state of the regulatory system of course closely reflects the underlying organisational and policy system.

b) Rule of Law

35. Important steps have also been taken to move towards a regime of rule of law. In 1999, the Constitution was amended to emphasize the concept of rule of law. This is widely recognized as a change of significant symbolic importance. Laws such as the Administrative Litigation Law (1989), the State
Compensation Law (1994) and the Administrative Licensing Law (2003) have contributed to shaping the legal boundaries of the power of the State executive organ.

36. In recent years the National People's Congress has increasingly asserted its power, through the drafting of laws but also in the design and monitoring of the budget. Therefore today, it would be misleading to view the NPC as a “rubber stamp” institution. It has occasionally been used by its chairs as a source of authority in the arm-wrestling of intra-Communist Party politics. In addition, delegates, representatives of provinces, have had a growing interest in a more active role of the NPC, as it provides the opportunity to defend local interests vis-à-vis the centre. The National People’s Congress has indeed a critical role to play in ensuring that major decisions are taken on the basis of an understanding of all the people’s diverse interests, and that conflicts are debated and resolved in a way which does not threaten the shared values which must underpin any successful society. The role of parliament is crucial as a representative body which ensures the transparency of the Government’s use of economic regulation and resources and its consistency with the enduring public interest.

37. Another most important advance has been the growing prominence of the State Audit Administration, whose annual reports have kept up criticism of the Ministry of Finance and other government agencies at the central and local levels. Beginning in 1999, the Audit-General has appeared each year at the National People’s Congress Standing Committee Meetings in June to present the Administration’s report on the audit of the previous year’s budget. In recent years this has become a popular annual event that attracts a great deal of media attention and follow up investigations by the press. This has generated continuing pressure to improve public sector management and provided support for budget reform through the National People’s Congress. The State Audit Administration has also been playing an increasingly important role in the fight against corruption.

I.4 - Information, Statistics and Public Participation

38. Several chapters of this study point out to weaknesses in the policy-making process. For instance, there is a lack of mechanisms to assess budgetary cost, economic impact, social and environmental impact, and the efficiency and practicability in implementation when preparing policy options.

39. This sub-part looks at three levers that contribute to the quality of the policy making process: access to information, statistics and public participation.

a) Access to Information on Public Affairs

40. Information on rules, regulations and projects and their implementation by public officials has become much more accessible in recent years, as shown in Chapters CCC (environment, IPR, etc.). Accession to WTO has been an important driver for more transparency in public affairs. Indeed, the protocol of accession includes several transparency commitments. The development of Internet (see Chapter CCC on e-government and also part IV), of the press and of television have also facilitated the diffusion of information.

41. This trend has been reflected in the legal framework. China does not have an Access to Information Act, but it should be noted that it is also the case in several OECD countries, and that of the others, most have adopted such a law only in recent years. But the obligation to provide information to citizens has been integrated in several sectoral laws. For instance, the Environmental Protection Law requires the State

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8 We only talk about information related to the design and implementation of economic and social policies. We do not address information in a broader human rights context.

9 Cf. WT/ACC/CHN/49 dated October 1, 2001: Transparency subsection.
Environmental Protection Administration (SEPA) and provincial bureaus to provide information about the state of environment in a variety of forms, including state of environmental reports, bulletins, brochures, news releases and others. These reports are now posted on Internet and are largely used by the media. Also, the Administrative Procedures Act mandates increased transparency in a wide variety of public policy areas.

42. This limited but nevertheless real progress in access to information reflects a more general evolution of the State. China has significantly departed from the culture of secrecy and of strict control of information, characteristic of the idea of the State as the means to control individuals. The opening-up observed can be seen as first moves towards a representation of the State which serves citizens.

43. Nuances should be brought to this general observation of progress made in the area of access to information. Limits to access to information derive from constraints brought by the political system one the one hand, and from the technical difficulties implied in the evolution of knowledge management (processes, management practices and mentalities), as would be the case in any State organisation.

44. First, there is still quite often too strict a limitation on which public reports should be made available to the public and/or a quality problem. To draw again examples from the environmental sector, some reports on environmental situation (especially in urban areas) are classified as confidential. Sometimes, information is released through case-by-case requests, in return for money or through personal relationships. While the development of access to information and the evolution of the underpinning representation of the State are real, the Party continues to control information, as well as all the media. The production and availability of data are constrained by political imperatives. For instance, it is difficult for the government to have an economically meaningful measure of unemployment, to launch an estimation survey on the size of the black economy or to assess the extent of smuggling.

45. Second, progress is slow at the local level. For instance, the US government reports that many local authorities are reluctant to provide copies of their local rules or regulations regarding IPR as well as any local enforcement decisions. The Chinese government argues that the provision of requested information is in itself a huge task, given the quantity of legislation.

46. Third, while information on projects is increasingly accessible, leading to public discussion on their consequences, information related to the evaluation of past projects is much less available. On the other hand, one should note the strengthening role of the National Audit Office (see Chapter CCC on corruption), which has published audit reports since 2001.

47. Despite these limitations, Chinese officials are very frank and open when they discuss the issues facing China, and judging by the writings of Chinese academics, access to information does not seem to be a problem for them. The key issue here is to contrast China's situation with the mass of information that is systematically released and widely-distributed in OECD Member countries, as part of on-going management. It should be stressed that transparency is not a goal per se but a means to improve the quality of policy-making. It also contributes to building consensus between regulating agencies, the regulated parties and the public. This is particularly applicable in a context in which there are serious co-ordination problems between public entities.

b) Statistics

48. Chinese statistics have come a long way from a pure reporting system in a centrally-planned economy to a system that increasingly relies on surveys and modern statistical techniques to service users, be they government or the public at large. Nonetheless many challenges remain. In recent years, the quality of Chinese economic statistics, in particular the growth rate of real GDP and other data has been repeatedly
questioned by several Chinese and western authors. Questions about data quality inevitably lead to questions about the institutional organisation of China’s statistical authority and the methods of statistical data compilation in China.

49. Some of the governance issues affecting the production of statistics are specific to this policy context, while the majority can be found as well in other policy areas. As described in Chapter CCC on statistics, there is still a legacy of reporting via ministries that limits the scope of the data collected and that limits the influence that NBS should have on the conception and quality of data collections. Second, complications persist between the central and the sub-national level of the statistical system. Often, local statistical offices are closer to local governments than to the NBS and this may create incentives that are not conducive to the compilation of high-quality statistical information. Stronger line structures between NBS and statistical offices at the local level and better enforcement of the statistical laws at all levels of the administration should help to advance on this matter. Third, there is a need to establish functioning channels to address complaints against violations of the Statistics Law. Fourth, there is a welcome but still sluggish move from enterprise reporting to survey techniques.

50. Other issues relate to transparency. Further efforts should be made to enhance transparency about data collection methods, and statistical methodology in general. Not only information about methods and source, data itself should also become more accessible to a broad range of users, for example through user-friendly web-sites with readily available, up-to-date statistics. Also, clear rules should be established on which data are available for the public for free and which data can be purchased through individual contact with the NBS. Transparent or at least standardised pricing for the latter would be desirable.

51. Finally, recognition of the desirability of a user-orientation of statistics is only in its beginnings. Further steps need to be taken to focus not only on data that reflect government priorities. Statistics are indeed an important tool for macroeconomic decision-making, but are also a fundamental input for individual decisions. Statistics become all the more important as China shifts towards a market economy. Productive debate and decisions – whether in local communities, the media, or the halls of government – require comprehensive, trustworthy and comprehensible information.

c) Public Participation

52. OECD countries have increasingly integrated the idea of direct public participation in the running of public affairs as a way to improve governance. With the transition to a market-driven economy and the decentralisation, this idea has becoming increasingly pertinent in China. Allowing for public participation in the regulatory process at all stages helps to critically review the legal system and stimulates the addressing of potential inconsistencies early in the legislative process. Public participation also increases the legitimacy of policies and decisions, thereby facilitating their implementation. This is becoming all the more important now that the weakening of old control devices has exacerbated the problem of policy implementation, making the need to encompass stake-holder interests in policy decisions more acute. Finally, the role of Local People's Congresses should also be thought about from the perspective of public participation, as a means to avoid the capture of the policy-making process by particular interests.

53. A lot of progress has been made. Chinese leaders have understood that pressure from public opinion efficiently complements enforcement efforts. Progress is particularly visible in the environmental field, which as in OECD Member countries, appears as a pioneer in governance evolution. For instance, Chapter 17 shows that the State Environmental Protection Agency has become interested in public disclosure because China’s pollution problem remains severe, despite long-lasting attempts to control it with traditional regulatory instruments. Various tools and mechanisms are being used to inform and consult citizens, and to involve their participation: public hearings, advisory committees, document reviews, informational meetings; forums; and Environmental Impact Assessments (official process of analysis of
the anticipated effects of planned projects or activities on regional and local areas). In spite of significant restrictions on the use of Internet, information technology has been playing an important role in promoting public participation.

54. However, there is still a lack of involvement of constituencies and stakeholders in policy making and implementation. Chapter 15 for instance shows that while the Chinese government has in recent years started to openly involve foreign companies in consultations leading up to the promulgation of FIE-related legislation, this process appears to be inconsistent and incomplete. Similarly, Chapter 14 explains that Chinese enterprises and other institutions have complained that competent intellectual property administrations did not extensively solicit opinions and comments when working out laws, regulations and policies. This insufficient consultation has led in some cases to inadequate protection standards.

55. OECD Member countries have developed extensive experience on public participation, as a general governance policy but also in specific policy fields such as the environment. This practical experience in most effective mechanisms, preconditions needed for their use could be useful for China.

II - Public Finance

56. With the new “scientific development” paradigm adopted under Hu Jintao and Wen Jiabao, the shift of emphasis from quantitative targets such as rates of growth to outcomes of economic growth will result in more scrutiny on government performance and require improved public expenditure management. "People-centred growth" implies better public services, which in turn requires reforming fiscal relations across levels of government.

57. This part gives an overview of four aspects of public finance: the structure of public expenditure, the intergovernmental fiscal structure, the tax system and the budget system.

II.1 - Where to Focus Public Expenditure?

58. Chapter 7 shows that the structure of public expenditure is characterised by a relatively low proportion spent on education, science and technology, and social welfare, and a relatively high proportion spent on public investment and public administration, including defence. Given the constraints on aggregate public spending, to improve this allocation structure, it is obviously necessary to reduce spending in some areas.

59. Analysis shows that public expenditure could be reduced on three fronts: i) administration; ii) capital expenditure (infrastructure) and iii) economic services. Much of the increase in spending on administration as a share of total on-budget expenditure is attributable to two salary increases granted to government employees. Successive attempts to reduce the number of public sector employees have not been very effective. It is indeed not easy to cut the public labour force. In the poorer areas, public sector employment functions as social safety nets. There is nevertheless an important margin of manoeuvre through increasing the performance of civil servants and streamlining redundant administration.

60. The share of China’s government spending allocated to investment is high by international standards, well above the OECD average. Only Korea presents a higher share. Part of the investment

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11 See the OECD Recommendation on Access to Information and Participation in Environmental Decision-Making.
12 Defence and related military spending is outside of the scope of this project.
spending has been motivated and justified by the government’s policy of promoting development in Western regions (the so-called Go West policy). Investment has also been undertaken by provincial leaders in order to maintain the growth rate locally. These investment decisions have contributed to the overheating of the Chinese economy observed at the beginning of 2004.

61. Finally, there is still too much State involvement in direct production or commercial activities in sectors which could be taken over by the market. In spite of important reforms, the State still appears too involved as a direct actor in sectors in which the market would be more efficient. In the context of the reform of PSUs, some units (for instance milk producers or entertainment book publishers) could quite obviously be taken over by the private sector. This reduction of the State’s involvement in production/commercial activities is all the more important where the public sector produces less value than it consumes; and where the private sector is growing more quickly, creating more jobs and wealth.

62. It should be noted however that in OECD governments pulling back from the delivery of commercial services dates only from two decades ago. As described in chapter 1, 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).

63. Complaints on the insufficiency of resources allocated are intrinsic of public sector debates. And tensions over resources are all the more severe in lower income countries. The Chinese government has had to face new spending demands, stemming from the evolution of the role of the State. Issues such as environmental protection or the intellectual property rights administration and protection were just not on the public agenda before the reforms. Chinese leaders have allocated substantial resources to support these emergent roles. To draw an example from the chapter on environment, the predecessor of SEPA was in 1974 a unit with a staff of twenty. To date, more than 100,000 people are involved in management, monitoring, supervision, statistical analysis, scientific research and environmental education.

64. But, as noted in Chapter 7, social welfare, education, science and technology appear to be under-funded. The fiscal structure further accentuates this particularly in poorer areas, as we will see in the next part. Indeed, on-budget expenditure of operating expenses for culture, education, public health, and science made up about 22 per cent of official spending in 2002, compared to an average of 28.6 per cent for OECD countries. Overall official expenditure for education, about 3.2 % of GDP in 2002, is still well below the long-standing government goal of 4% of GDP. Public health remains one of the most underfinanced areas; related outlays fell from 4.2 % of total on-budget spending in 1994 to 2.8 % in 2002. The entry of private capital in the health sector alone (see next sub-part) is unlikely to meet the increasing needs for healthcare services. China’s public spending on science and technology has also been relatively low by international standards.

65. There is no magic or scientific formula which can define how a structure of public expenditures should be. The situation in OECD countries gives interesting landmarks for comparison, but it could be argued that these comparisons are of limited pertinence given the fact that China and OECD countries are at different development stages. But on the other hand, to ensure sustained growth, China has to achieve technological upgrading and to further develop internal consumption. Also, rising inequalities and poor social services tend to create tensions throughout the country. These economic and social considerations demand a shift of the public expenditure structure towards more spending on education, health and science and technology.
II.2 - A Dysfunctional Intergovernmental Fiscal System

66. As exposed in Chapters 6 and 7, compared to other countries, the organisational structure of the Chinese fiscal system is exceptional in two important respects. First, it is highly decentralized: the central government accounts for only 30% of total budgetary expenditures (a share that has crept up to 35% in 2001). The rest is distributed among the four sub-national tiers, with 55% spent at sub-provincial levels. By comparison, sub-national governments on average account for only 13% of total budgetary expenditures in developing countries, and 35% in developed countries. This decentralization is even more notable because China is virtually unique among countries in the world in assigning responsibilities for providing vital social services such as social security, basic education, health care and public safety to local governments. Cities at the third and fourth tiers account for all expenditures for social security: pensions, unemployment insurance, and other income support and welfare schemes. Counties and townships (fourth and fifth tiers) are together responsible for providing basic education and public health for the rural populace – these two tiers account for 70% of budgetary expenditures on education, and 55-60% of expenditures on health.

67. Second, revenue and expenditure assignments are significantly mismatched. The fiscal revenue is also quite decentralised but less so then expenditure, in particular since the 1994 tax reform which significantly increased the central government's overall share of total revenue. The decentralisation process occurred in an incremental and uncoordinated fashion. Thus, by the late 90s local governments at the county and township levels were saddled with unusually heavy expenditure responsibilities including education and health, and supported neither by an appropriate set of revenue assignments nor an effective system of transfers to ensure they could meet minimum service provision standards. This has led to a large gap between available financial resources and expenditure responsibilities. Transfers from the central to the provincial governments to bridge the resulting gap have risen substantially. However they only imperfectly cover the gap between expenditure responsibilities and tax revenue resources. Many earmarked transfers arrive late in the year and in unpredictable amounts.

68. This dysfunctional intergovernmental fiscal structure has important negative consequences.

69. The provision of services to the local populace is vulnerable to variations in local fiscal health, and inequality has been rising, among provinces but more severely even below the provincial level. The decentralisation process has aggravated inequality in terms of social welfare, in particular between rural and urban areas. For instance, the State's share in total health spending in rural areas declined from 21.5 % in 1978 to 10.5 % in 1991. The shortage of revenues at the lower tiers and especially in poor regions constitute a bottleneck to national policy implementation in sectors of social security, basic education, health, in which as explained previously, China should be spending more.

70. A major consequence has been the multiplication of illegal taxes and fees. According to some estimates, these illegal fees could well equal official budgets. This situation is further aggravated at lower sub-national levels, in counties and townships. The exact situation seems to vary from one county to another.

71. This fiscal situation also contributes to maintain unclear links between enterprises and local governments, which hinder the restructuring process. The volume of loans to finance uncompetitive companies has continued to increase. As local governments cannot borrow funds, they contract loans to finance companies and make arrangements to recuperate part of the funds. The maintenance of these companies is also a source of tax revenue.

72. The shortage of funds bias the enforcement of policies. For instance, in the environment field many EPBs are heavily dependent on collecting pollution levies to cover their operating costs. It is in then in the
interest of EPBs to keep enterprises polluting and pay their pollution levy, rather than to comply with discharge standards and stop paying. It also contributes to corruption and rent-seeking behaviours. When pay arrears are serious or operating funds not sufficient, the temptation is great to use official power to extort bribes from citizens or companies. Some observers describe a real “IPR protection industry”, as bribes are often given to activate the participation of the different actors in the investigation of cases of infringement. At the same time, the same officials may receive bribes from infringing companies to turn a blind eye on their activities.

73. It should be noted that the mismatch between revenues and expenditure assignments is not the only factor behind the problems exposed above. These also point to weak accountability and control mechanisms at the local levels, and between the central government and the local governments, in particular the sub-provincial level. Also, sub-national government entities do not always have the necessary competencies to properly handle new responsibilities, as developed in the chapter 9 on civil service.

II.3 - The Tax System

74. With its transition to a market-oriented economy, China has gone through major tax reforms in the last two decades, implementing significant measures to improve governance in taxation, including unifying tax laws; equalising tax burdens; simplifying tax system; rationalising the decentralized system; and standardising revenue allocation method between the central and local governments. However, more needs to be done to improve China’s tax system so that transparency, stability and the rule of law will become the guiding principles.

75. In tax policy, a country’s tax system should provide a level playing field to participants in its market in order for the market to work in the most efficient way, while raising necessary revenue for the government. China’s tax system was overhauled in 1994. After 10 years of operation, a number of issues have emerged, which call for a new round of reforms. The quick transition to a market economy and China’s accession to WTO also indicate the need for tax reform. These reforms will embrace, in particular, transforming the production-type VAT to a consumption-type VAT, fine-tuning Excise Tax, unifying the two Corporate Income Tax codes (one for domestic enterprises and the other for foreign investment enterprises and foreign enterprises), reforming Individual Income Tax, restructuring local taxes and streamlining agricultural taxes.

76. On the implementation side, any tax system is only as good as its tax administration. In China, a more effective tax administration will make a significant contribution to improving governance, inter alia, in respective of transparency, level-playing field and rule of law.

77. Over recent years, there has been a consistent increase in the ratio of tax revenue to GDP: the ratio has risen from 11.6 percent of GDP to 16.6 percent in the five years from 1998 to 2002. The impressive upward trend can be attributed, in fact, to the major organisational reform in 1994 when SAT became independent of the MOF and was given a wider mandate and more resources, as well as the considerable efforts to improve efficiency and effectiveness of tax administration. While the 1994 reform led to improved governance in taxation with the better oversight over local tax offices, the efforts to build a modern tax system are far from complete.

78. From the governance point of view, emphasis should be placed on the following aspects. First, the current organisational structure of tax administration based both on “type of tax” and “function” could be flattened and streamlined through centralizing functions, merging replicated and overlapping functions. Second, communications and coordination between the state and local tax authorities should be improved. Third, tax authorities should aim at improving voluntary compliance, instead of relying on revenue targets.
Experience shows that better compliance would not only lead to more tax revenue but also to less tax-induced distortions. Fourth, administrative regulations in China should be simplified. Simplification of regulations could lead to a substantial reduction of compliance cost for taxpayers as well as administrative cost for tax authorities. Fifth, it is of vital importance for China to develop a unified computer system to integrate the varied functions of tax collection and administration. Last but not least, appropriate training should be given to those who deal with increasing important and complex issues relating to multinational and large taxpayers. China has some new ideas about large taxpayers units to deal effectively with these taxpayers, and these ideas are still being carefully considered by local as well as head offices.

79. With China becoming an Observer on the OECD’s Committee on Fiscal Affairs, it is expected that China will associate itself more closely with OECD’s work on taxation, and in doing so, will benefit from the wealth of knowledge and experience of the OECD Member countries and vice versa.

II.4 - The Budget

80. Under the planned economy, resource allocation was made primarily by the plan, controlled by the then State Planning Commission. The budget played only a supporting role in financing the plan. Following the opening of the Chinese economy in the 1980s, the modernisation of the budget process at the central and local levels lagged behind other economic reforms. But since 1999, as described in Chapter 6, a broad package of reforms in budget management has been introduced, covering reforms in budget preparation with the introduction of departmental budgets as well as reforms in budget implementation. Although some measures, e.g. the detailed budgeting and norm-setting, appear to run counter to the trend in OECD reforms in budget management, they can be understood as a part of the process of regaining control over the basics.

81. With the reforms to date, China appears to be, step-by-step putting in place the infrastructure necessary for building a modern system of budget management. Progress has also been visible in the budget implementation and in financial management. For instance, the 2003 report of the State Audit Administration noted approvingly that while “(t)he 1998 audit (had) identified violations amounting to 16.4 billion Rmb (...) by 2001 the amount of such violations had fallen (...) to 2 billion Rmb, with a pronounced reduction in major violations at the central-department level.”

82. However, in spite of the many advances, the budget management system remains marred by several weaknesses, impeding the budget management system to be a fully effective tool for policy management or implementation.

83. On-budget public expenditure represents only 21.7 % of GDP. This is of course the part of the funds that are the most manageable, that can be discussed and allocated in a place where pros and cons are discussed and arbitrated, above and beyond direct or local interests. Extra-budgetary expenditures remain large Off-budget expenditures financed by unauthorised fees and charges, often on an ad-hoc basis (for example charges imposed on live-stock slaughtering or other activities of farmers) are not legally sanctioned and no official statistics of their amounts are systematically compiled. There are on-going efforts to move extra-budget and off-budget activities onto the budget.

84. The Ministry of Finance still does not have comprehensive oversight authority on spending. Coordination between central and local governments is improving but remains weak and revenue forecasting remains weak. In part due to the fiscal gap described previously, extension of improved budgeting to the sub-national levels is limited. And finally, compliance with existing laws and regulations needs strengthening.

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13 Li Jinhua (2003).
85. As analysed in Chapter 6, one could say that, to date, the Government has focused mainly on tackling the technical issues, and has shied away from reforms that more directly involve political challenges. In particular, there has also been little public discussion of the need for a major realignment of the intergovernmental fiscal system in spite of the many changes underway since 2000, as a result of reforms in the rural sector. Other important and needed steps include a redefinition of the role of government and the refocusing of budget priorities and limiting policy initiatives outside the budgetary context to improve orderly prioritization. Finally, judging from the recent audit reports of the State Audit Administration, the many difficulties government faces in enforcement highlight its continuing inability to enforce fiscal discipline and hold spending units accountable for results. Strengthening accountability mechanisms and enforcing aggregate fiscal discipline constitute the critical next challenges for reforms in the next phase.

III - Organisational and Management Issues

86. This part first goes through three public sector management issues that determine the capacity and performance of the public administration: the horizontal organisation and related problems coordination, the vertical organisation and related problems of organisation and the civil service. It briefly describes recent efforts undertaken by Chinese leaders to introduce information and communication technologies to modernise their public administration.

87. Finally, this part depicts the challenge of the reform of the public services units. These structures inherited from the planned regime (coexisting with administrative units, productive units and agriculture units) are defined as “social service organizations established by the state for the purpose of social public benefit”. The stakes of the reform of Public Service Unites (PSUs) are considerable as there are 1.3 million PSUs, employing 25.5 million people. The problem is multi-dimensional: financial, organisational, managerial and regulatory.

III.1 - Horizontal Organisation and Co-ordination

88. The transition towards a socialist market economy has brought changes in the role of the State, and a redefinition of the mandates and relative weights of State organisations. Successive administrative reforms (in 1982, 1988, 1993 and 1998, and most recently with the change of government in 2003) have aimed to rationalise the administrative organisational structure, and reduce the number of civil servants. Great strides have been made notably during the latest reorganisation, with the number of redundancies and conflicts in mandate being reduced.

89. Yet, a number of problems remain, which put a brake on potential progress on several policy fronts.

90. For instance, if the National Development and Reform Commission used to play a central role under the planned economy as the main organisation in charge of the design of the plan and the supervision of its implementation, today its core role is questioned by in increasing importance of Ministries such as the Ministry of Finance. Indeed, in the present setting, the capital budget is set by NDRC, separately from the recurrent budget, overseen by the Ministry of Finance. Capital spending decisions are not required to coordinate with fiscal authorities even when these decisions will create large recurrent costs downstream. Potential overlaps also exist with the Ministry of Commerce (foreign investments for instance) and the Ministry of Agriculture.

91. Similarly, staffing decisions, which have major spending implications, are made by the State Commission Office for Public Service and its local branches, with little consultation with fiscal authorities. For example, the decision taken by then-Premier Zhu Rongji to significantly increase civil service salaries greatly increased government financing requirements, but MOF had little influence over the decision.
92. Within particular sectors such as for instance the agro-food sector, successive partial reforms have contributed to create a complex “spider web” of institutions. The moves towards liberalisation of production, pricing and marketing have led to the creation of new institutions, or to the redefinition of mandates of old ones. At the same time, the production and trading of commodities considered of strategic importance, such as in the staples food sector, have continued to be managed through state-linked enterprises. Chapter 16 for instance shows the overlapping roles of the numerous institutions involved in the grain administration system. In such unclear settings, it is difficult to create incentives for cooperation and co-ordination. The competition for resources and authority then tends to reinforce the tendency to compartmentalisation.

93. In the field of intellectual property rights (cf. Chapter 14), the departmentalisation of interrelated duties is quite dysfunctional. The violation of a patent right is often linked to a violation of a trademark, but patents and trademarks are registered with different government agencies, leading to important efficiency losses. For the production of statistics (cf. Chapter 8), the role of the National Bureau of Statistics has been growing, with a ten-fold increase in staff since 1976, but government departments continue to collect their own data from, for instance, town-ship run and village-run collective enterprises, or from state companies, legacy of the planning system. This leads to duplication of statistical work. In the environment sector (cf. Chapter 17), the relations between the State Environment Protection Administration (SEPA) and the State Ocean Administration are contentious with regard to the monitoring and the responsibility over the ocean’s coastal environmental quality. SEPA relations with the Ministry of Water Resources on watershed management are also tense as both agencies consider watershed environmental management as their priority.

94. In some instances, the hierarchical structure between State entities inherited from the past affects the efficiency of policy-making. For instance, the National Statistical Bureau used to be simply an office compiling data provided by other ministries. If it is today only half a rank below other Ministries, it has only a guiding influence over the other departments compiling statistics. Quite similarly, the State Environmental Protection Administration does not have the power to influence the policies undertaken by other ministries.

95. The leading groups may well create bridges between leaders at the apex of the political system and the major state entities of a particular xitong, but they also add on the already burdensome array of organisations and procedures of the Party and the State. This may contribute to creating situations in which responsibilities are not limited by institutional boundaries but through the multiplicity of lines of reporting by functional area.

96. In addition to the successive rounds of administrative reforms and to the creation of leading groups at the top for identified xitongs, several types of measures have been tried, not always with great success.

97. In some cases, institutions have been promoted to a coordinated role, as for instance the State Intellectual Property Office, but without proper resources or powers. On watershed environmental management, the State Council attempted to address the problem by setting up bureaus, subordinated to both SEPA and the Ministry of Water Resources, but the results have not been positive.

98. Often, existing organisations, defending their mandates, have opposed reforms and have thus contributed to perpetuating problems. Also, the success of efforts to reform the organisational structure is dependent on the clarity of the relevant public policy objectives. In cases such as the agro-food sector, further reducing public intervention and setting up appropriate incentive systems would be more effective than setting up new institutions and rationalising old ones.
III.2 - Vertical Organisation and Co-ordination

99. If China is highly fiscally decentralised, the regime continues to be highly centralised politically. Coordination between central and local governments is improving, but remains weak. Policies made by central government usually have financing implications for local governments, but local governments are not always consulted before rollout. For example, most local officials reportedly learned of the salary increase for civil servants from TV broadcasts even though the costs were mostly borne at the local level. But improvements are clearly evident in consultation with local governments in recent years. For example, the recent reforms in rural fees and agricultural taxes have been worked out with local governments, but compensation remains only partial.

100. At a more micro-level, the multiplicity of horizontal and vertical leadership relationships creates complex situations in which it is not always easy to foresee which authority has priority over others. Box 2 describes the complex pattern of vertical organisation of executive power. The situation becomes even more complex for policy decisions or projects that involve several xitongs, posing a quite inextricable coordination problem.

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14 This part and in particular the presentation of Box 2 is greatly inspired by K. Lieberthal (1995) “Governing China”.
Box 2 – The TiaoKuai Guanxi

Each Ministry or Bureau has entities at the different territorial levels, at least down to the county level. Departments, governments and Party organs at different levels are linked following a complex pattern of vertical relationships (tiao) and horizontal relationships (kuai). The term tiao kuai guanxi, literally the relationships between the vertical and horizontal lines, refers to the complex issue of which authority has priority over others.

To present this pattern, we take here the example of the Zhongshan county statistical bureau. This hypothetical statistical bureau under the Zhongshan county government would be subordinate both to the Zhongshan county government and the statistical bureau under the Guangdong provincial government. But these relationships of subordination are of different nature. The Zhongshan county government will exercise administrative leadership (xingzheng lingdao) on the statistical bureau: this involves funding, appointment of staff including senior positions and supervisory functions. The Guangdong provincial statistical bureau will exercise business leadership (yewu lingdao) over the county bureau.

At the same time, the Zhongshan county government must answer to both the Zhongshan county Communist party committee and the Guangdong provincial government. In addition, the organisation department of the Zhongshan county Communist committee will strongly affect the career opportunities of the leaders of the Zhongshan county statistical bureau, who must also obey party discipline as members of the party committee of the statistical department.

101. The "tiaokuai guanxi problem" has important consequences on policy and decision-making (see for instance Chapters on IPR, environment and statistics, and also Part VI for further developments). As a result, the system is far from a pyramidal pattern, in which decisions would be taken at the top and implemented smoothly at lower levels. The complex multiplicity of hierarchical lines leads to unclear responsibilities and accountability relationships, which increase the discretion of public officials, for better and for worse. This situation facilitates the interference of local leaders in the implementation of national policies, but also the development of corruption practices.

102. The resulting weak governability of the State apparatus is all the more problematic in an increasingly market-driven system. The planning system tended to limit the "world of possible" and thus the scope of power of public officials. Economic planning resolved ex ante the possible contradictions between different objectives. In such a context, the multiplicity of overlapping hierarchical links was not so problematic and could even well serve to control a huge body of civil servants. The introduction of market mechanisms in the economy together with decentralisation have loosened the centralised top-down links between top leaders and the mass of public officials, as they are obliged to turn increasingly to servicing citizens and private businesses. In addition, a market-driven economy hardens budget constraints and thus imposes the obligation for efficiency on the State.

103. For many issues that do not fit within the bureaucratic domain of a single organisation, the pressure is then great to push decisions up the bureaucratic ladder. It may well happen indeed that the only level of the political system where one body has authority over everyone involved in the project is the Centre. There is thus a natural tendency for the conflicts among the various bureaucracies to be pushed “up” to the Centre for resolution. Also, because of this general fragmentation of authority in the system, resolving a matter below the Center often requires building a consensus among an array of relevant officials. This need to construct a consensus generally predisposes officials to negotiate with other relevant officials from an early point. This reinforces the functional importance of relationships or guanxis, leading in some instances to clientelism and corruption.
104. But most importantly, this complex institutional setting comes to justify a strong horizontal, and thus locally involved, role for the Party\textsuperscript{15}. The Party thus does not solely play a vertical linking role between top leaders at the centre and the local level. As local government heads (governors or mayors) and local people’s congresses are not powerful enough to achieve this task, local party committees play this needed role of leading and coordinating the work of the various state institutions at each level. As developed afterwards, this needed involvement of the Party in local affairs in turn constrains an evolution towards market mechanisms.

105. Reform efforts have been undertaken in various fields to reinforce vertical lines of authority. Tax is the field in which such reforms have been taken the furthest. In the area of statistics (cf. Chapter 8), when appointing the head and deputy-heads of the provincial statistical bureau, suggestions by the NBS need to be taken into consideration. This amounts to a de facto veto right for the NBS. The same pattern is repeated at the municipal and county level; the suggestions of the next higher-level statistical bureau have to be sought before appointing the head and deputy-heads. More recently, the implementation instructions to the Statistics Law (NBS, 2 June 2000, Art. 29) go a step further in that they stipulate higher-level statistical bureau approval for appointments of all “mid-ranking” and higher statistical “special” and “technical” regular staff, although this may in practice not amount to much more than an advisory role.

III.3 - The Civil Service

106. Since 1993 the Chinese government has been taking significant steps to reform the country’s civil service system. As described in Chapter 9, the scope of reform has been wide, touching recruitment and selection, training, appraisal, rewards and punishments, compensation, discipline as well as other areas.

107. Despite an overall positive evolution, progress brought by these reforms has touched unequally different parts of China. Indeed, China’s civil service system can be viewed as two systems – one that is relatively performance-oriented, selects ‘the best and brightest’ through competitive mechanisms, links rewards to performance, and does not tolerate indiscipline and corruption – and another that is more traditional, operates as an employer of last resort, selects based on many different criteria some of which may be irrelevant to the job, ties rewards to positions, and tolerates relatively high levels of indiscipline and corruption. (There are undoubtedly many gradations in between.) In China considerable evidence indicates that the performance oriented systems operate primarily at the centre and in the richer coastal areas, while the traditional systems operate in the poorer, less developed hinterland.

108. Improving the civil service systems in these poorer areas depends in no small part on improving levels of economic development. Development is most likely with a highly competent and committed bureaucracy. Intervening to break out of the symbiotic relationship between poverty and inept bureaucratic leadership is an important task for the foreseeable future.

109. Chapter 9 proposes recommendations to address remaining challenges. To enhance legitimacy and accountability and to attract the best possible candidates to work for the government civil service personnel policies and practices should be as transparent as possible. Also, the practice of permitting entry to the civil service outside the established mechanisms should be reduced and eliminated. To strengthen the civil service’s meritocracy, all candidates for entry-level positions including de-mobilized soldiers should be required to take and pass the civil service entry examination. Transfers to poor areas should focus on improving human resources in those areas through training and transfers in of experienced officials from more developed areas. Finally, salaries for civil servants should be maintained at a competitive level, determined locally. To ensure this, pay level surveys should be carried out regularly and their results published. Pay awards should be based in part on the surveys.

\textsuperscript{15} JP Cabestan contributed this interesting idea during the brainstorming meeting organised at the OECD in 2003.
III.4 - E-Government

110. The Chinese government has a sophisticated understanding of the potential of e-government as a factor for public sector modernisation. Extensive planning for the use of information resources within the government, but it is still too early to tell if the strategies have translated into appropriate action at the agency and local level. In particular, local governments will play a key role in implementation and the central government has few levers to influence their approach or strategy.

111. The primary barriers to e-government are the same that those that afflict China in general: insufficient rule of law, lack of performance management indicators and monitoring processes in the public administration, an old-style public administration culture with few incentives for innovation. Given current attention on e-government, it is important to focus political will on addressing these broader problems. The stakes are high, both in terms of allocation of the ICT resources and in terms of the opportunity cost of focusing on e-government as a major element of the reform agenda.

III.5 - Public Service Delivery and the Reform of Public Service Units

112. This broad terminology of public service units (PSUs) catches a galaxy of very different organisations. While some are engaged in administrative activities (supervision and management, qualification) and market intermediary functions (consultation and coordination for enterprises), the bulk of PSUs carry out activities in education, health, science and technology, culture, public infrastructure development and agriculture.

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

114. The Chapter on Higher Education gives a good illustration of the increasingly complex situation that has developed around PSUs, describing the evolution of the financing and of the organisational forms in this sector. In the past two decades, higher education institutions (HEI) and the higher education sector in general underwent a radical transformation. HEI used to be affiliated with ministries at the central level, but 85% of them were decentralised to provincial or sub-provincial level. HEIs were encouraged to find alternative sources of financing as the central and the local budgets could not finance the expansion of the sector that was needed. As a result, today, there are 4 sources of financing: central budget (even for HEIs affiliated to sub-national governments), sub-national budgets, students' tuitions and fees and private sector contracts. Only 50 % of the total budget of HEIs is covered by public funds.

115. Another important evolution in the sector of higher education has been the development of private institutions, called min ban. Today, min ban students represent only a small percentage of the total population of higher education students, but the weight of these institutions is growing rapidly. Accession to WTO has prepared the way for an increased participation of foreign actors in this sector.
116. Overall that is why, while public education expenditure relative to GDP is less than in countries such as Brazil and India, the total education expenditure relative to GDP, including private financing, is higher in China than in these two countries.

117. This increased flexibility and opening of the HE sector has allowed a rapid increase in both the volume of higher education and its quality. The number of students has been multiplied by 15 in 10 years and private capital has allowed the modernisation and renovation of HEIs. In addition, from an equity point of view, as the economy becomes market-driven it is fair that students who benefit from higher education should pay for this important asset for their professional life. As Chinese values give a high importance to education, the idea of private financing of studies is easily accepted in Chinese society. One could also say that the one-child policy will facilitate this financing, as soon, each young student will have four grandparents ready to contribute to her education. Also, this strategy may contribute to limit the development of corruption, which commonly thrives when there is a gap between the supply of public services and demand.

118. On the other hand, this evolution is not without problems. First, a mode of financing relying heavily on private sources tends to increase social and territorial disparities. Loan schemes have been introduced but do not function very well. Second, it is not uncommon that professors working in public HEI combine it with teaching in private HEIs or prefer to spend time in working on lucrative contracts (with the private sector but also with international or foreign agencies), to the detriment of basic teaching assignments or support to students. Third, the management of resources coming from private sources is not always transparent or done to serve the public interest. As a result, quality is uneven and difficult to monitor. Finally, the development of other sources of finances has not always been accompanied by efforts to increase the efficiency and performance of the HEIs.

119. After a series of piecemeal reforms, often implemented sector per sector, the Chinese government is embarking in an important reform of PSUs. The reform today is driven by three issues: the need to clarify what should be the role of the State in the different sectors of operation of PSUs, the need to improve the performance of PSUs and the need to clarify the management and accountability of PSUs to ensure they do serve the “purpose of social public benefit”.

120. The analysis of the situation in China, in light of the experience of agencies with “distributed governance”, suggests a few possible lines of action (cf Chapter 1, but also the chapters on education and on environment). As a first step, sector per sector, central level authorities should conduct a review of the responsibilities assigned to PSUs and assess the gap between these responsibilities and assigned resources. Narrowing the scope of operations, concentrating efforts on a small number of priority issues and focussing on problems which are potentially solvable, i.e. redefining what should constitute the core of public action, is a simple way to increase the efficiency of public action.

121. Second, for each service or good provided by a PSU, policy-makers should decide what should be the most appropriate organisational form for its delivery. In this regard, it is important to stress that certain conditions have to be fulfilled for an organisational form to deliver the expected positive effects. In other terms, the choice of organisational form for public action in theory should not only be guided by fiscal considerations and related issues of equity (who should pay for what), and considerations of efficiency (including the fact that it is necessary to introduce some degree of flexibility in formulating public actions in order to take into account local factors). Organisational form decisions should also take into account the broader organisational and management context in which a public action will take place.

122. To be more explicit, the experience of OECD countries shows that delivering public services through arm’s length bodies or agencies works well if: i) the central government retains competencies in the policy field; ii) the agency has sufficient competencies; iii) the respective responsibilities and the incentives and
constraints that organise the relationship between the central government and the agency are clear; iv) the central government has the capacity to monitor and fine-tune these arrangements; and v) an external audit body has the mandate to audit the agency. The increased autonomy and flexibility that have known PSUs does not mean that the government and line ministries should play no role at all – but rather for an evolution of that role. In the context of the PSU reform, it is important that measures be taken to strengthen the accountability relationship between those PSUs that will keep this agency-like type of status and the government ministry to which they are affiliated. If the operating context does not allow for the listed arrangements to be put in place efficiently, it might be wiser to prefer integration in line ministries.

123. Third, within PSUs, measures should be taken to improve the human resources management, and in particular with the management of senior management, and to improve the budget allocation and financial management mechanisms. Indeed, the need to increase the efficiency of PSUs is one of the main drivers of the current reform. Introducing market mechanisms and increasing the autonomy of their management do not suffice to achieve this.

IV - Adjusting to a Market Economy: Creating an Institutional Framework for Market Forces

124. Market-driven economies require no fewer institutions then planned economies. The “invisible hand” of the market does not operate in an institutional vacuum.

125. This part examines the progress made in China in building the necessary institutional framework for market forces. It first looks at the labour market and labour protection institutions and their incidence on inequalities. It then examines the efforts made to reduce the administrative barriers and those made to build a level playing field with sound rules of competition. Finally, it looks the progress made in reforming the governance framework of sectors in which State intervention remains high, and in the development of a corporate governance framework.

IV.1 - Labour Protection and Market Integration

126. China’s economic reforms have established a new relationship between enterprises, workers and the State, placing the public administration at arm’s length from most economic decisions in the market. Box 3 recalls the major steps that have marked the evolution towards a market-driven economy. The 1994 Enterprise and Labour Laws created a new employer role, separate from government, permitting enterprises to concentrate more on their business functions.
Box 3 – Major Steps of the Evolution towards a Market-Based Economy

The evolution from a system of production and delivery through State entities integrated in the core of the State apparatus, to a system in which State presence remains strong while allowing for the interplay of market forces is a complex task.

In China, the main steps have been the following (not a strict chronological order):

- Authorisation to run private businesses
- Separation of State Owned Enterprises from Ministries
- Diversification of ownership in some SOEs (partial privatisation)
- Creation of State Assets Supervision and Administration Commissions (SASAC) to oversee non-financial SOEs
- Decision in 1999 to maintain state control, through ownership and/or regulation, on three main types of enterprises (in addition to enterprises related to state security): natural monopolies, important goods and services and high and new technology industries, while withdrawing progressively from other areas.
- At the same time, opening up in some of these sectors, such as banking, to competition from private actors
- Elaboration of the corporate governance framework
- Party officials are no longer allowed to work in state-owned enterprises

Today the private share of the Chinese economy has become more important than the public one. Private businesses represented already 56% of the GDP in 2003 (49% in 1998). This figure shows the successful shift of the Chinese economy toward private ownership.

127. Chapter 11 focuses on three functions that fall under the Ministry of Labour and Social Security at national level, and under Labour Bureaus at lower levels: employment services, labour inspection and social insurance. The existing institutional structure appears to allow for the needed coordination to achieve priority goals, such as the promotion of formal employment contracts and enrolment in social insurance. Specialised office networks have been developed in urban areas, which appear relatively well equipped by international standards.

128. In contrast, all formal labour market institutions have limited application outside urban formal enterprises. This situation is not uncommon in developing countries, as implementing labour laws and social insurance is generally difficult in less-productive rural and informal segments of the labour market. If the household registration system (*hukou*) has been partly liberalised and restrictions on recruitment of migrants abolished, the existing institutional framework for labour protection contributes to maintain a segmentation of the labour market, which in turn affects economic development. Implementing labour law and social insurance is generally difficult in the less-productive rural and informal segments of the labour market. But real incomes are rising in most parts of the economy, and the present scale of rural-urban migration and economic interdependence makes it urgent to reduce institutional inequity as far as possible.

129. Concerning employment services, both OECD and Chinese experiences suggest that the counselling of unemployed job seekers who receive public support (unemployment benefits or special support of the laid-off) should have high priority. In addition, labour bureaus should play a role as intermediary between rural migrants and urban employers, in order to progressively eliminate discrimination between workers according to their *hukou* status.

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130. The labour inspectorate cannot monitor all enterprises, but it frequently takes action in response to individual complaints. By making this service relatively accessible and effective, the inspectorate has become a safety valve that may be particularly important in China, where other possible channels for workers’ complaints, such as trade unions, are not independent of political powers or enterprise management. As a further concern of special importance in China, the country needs to remove grounds for suspicion that it tolerates poor labour standards in order to attract foreign investment. This appears to require more inspections of working time and wage payments. Foreign actors and NGOs can play a complementary role in putting pressure on some enterprises, but they cannot replace an effective labour inspectorate.

131. The governance of social insurance involves many decentralised decisions about contribution rates and benefit levels. In contrast to most OECD countries, which standardise these decisions at national level, China’s size and diversity impose flexibility. The national government encourages provincial governments to harmonise the system and to centralise the pooling of social insurance funds in each province. But contribution rates are often reduced for certain groups, especially rural migrants and workers in small private firms, who may also be offered a choice between alternative insurance packages. While such differentiation is justified, it may not be sufficient to attract rural migrants unless the accumulated entitlements are portable. The social insurance system as a whole needs to be revised with a view to actual mobility patterns in the labour market. The pension programme, in particular, is unsuitable for migrants because it requires ten contribution years in the same locality. This limit should be abolished, and the administration should be equipped to take account of all contributions made by an individual during his or her lifetime, regardless of where they were paid. A more centralised administration might facilitate this, but with good co-ordination it should also be possible in a decentralised system.

**IV.2 - Towards Competitive Markets with Fair Rules of Competition and a Sound IPR Regime**

132. Competition is the basic driving force of market-economies. A first sub-part explains how, in its transition to a "socialist market economy", China has taken important steps in order to reduce restrictions on enterprises’ ability to enter, exit, or otherwise respond efficiently to consumer demand, in particular with the reform of the administrative approval process. A second sub-part takes stock of progress made on the definition of the rules of competition and of the related issue of the protection of intellectual property rights (IPR).

*a) Reform of the Administrative Approval System*

133. Government's control on economic activities through administrative approvals has continued to be an important characteristic of the Chinese economy. This a legacy from the planned system, in which government controls penetrated virtually all sectors of economic life -- from market access to supply of raw materials, from price setting to sales of product.

134. In recent years, the reform of administrative approvals has become a high priority of the Chinese government, as reflected by the creation of the Leading Group for Administrative and Examination Approval System Reform in 2001. Important reform measures have been taken recently (cf. Chapter 3), with the adoption of the Plan for Administrative Approval System Reform and of the 2003 Administrative Licensing Law (which covers a subset of the items subject to administrative approval items, those primarily relating to business activities). The related Administrative Approval reviews have led to the elimination, at the central level, of 1795 approval requirements, out of a total of more than 4000 -- thus showing the importance of administrative control beforehand. The Licensing Law narrows the scopes of activities for which a licence is required, and even in cases where a licence is required, encourages self-regulation. As noted in Chapter 3, it is yet too early to assess its impact but the significant efforts made to guide public bodies and civil servants for its implementation tend to indicate the high level of political will.
The Licensing Law should make the licensing process less burdensome, more open and less subject to delay. Regulatory barriers to market entry will contribute to exist, but will need to have a stronger connection to the several concepts of the public interest specified in the Law.

135. In parallel, in July 2004, the State Council issued a Decision Concerning the Reform of the Investment System to streamline the investment approval process (cf. Chapter 15). This Decision simplifies the process through a single application report, and to a greater delegation of approval powers to local authorities. The revised Catalogue for Guidance of Foreign Investment adopted in February 2002 also represents a major step forward in FDI regime liberalisation. In view of the experience of OECD countries, China should target in the long run to replace the catalogue, which lists prohibited, restricted and encouraged categories, with a single list of sectors barred to foreign participation.

136. Three important messages emerge from the different chapters of this project.

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

138. As stressed in Chapter 16, such evolution of the role of the government implies a profound shift in mentalities and in the relations between State and non-State actors: from a top-down hierarchical paternalistic approach, implementation through direct control and objectives formulated as outputs and capital targets, to one that is service-and-needs oriented, responsive and accountable, servicing the needs of citizens and economic actors, setting up appropriate incentive systems and creating circumstances that allow winners to emerge. It also implies a change in competencies for mid-level managers, who have to learn to operate in a very different environment. This dimension of the transition should not be overlooked by Chinese leaders, and in this regard, opportunities of exposure to foreign public officials and experts should be multiplied.

139. Second, efforts made to streamline the regulatory environment of private businesses should be pushed further. Indeed, the operating environment for businesses continues to be quite complex, creating opportunities for extortion and bribery. In some cases, successive piecemeal reforms have added on to complexity of the regulatory framework. As noted above, recent efforts will certainly contribute to the improvement of businesses’ regulatory environment. As described in Chapter 5, China has simplified the administrative regulations in the area of taxation, introducing one-stop shops, by simplifying procedures for permits and licenses and by putting time limits on decision-making. Although commendable, more work should be done. The costs born by enterprises linked to the complex administrative environment affect the profitability of foreign investments in China. Again the experience of OECD countries with reducing administrative and regulatory burdens on enterprises could be pertinent for China.

140. Finally, based on the experience of OECD countries, it would be beneficial for China to progressively adopt a “national competition policy”, referring to a systematic approach to government regulation by which laws and regulations should not contain restrictions on competition and consumer
choice that are not necessary to achieve their goals. The idea is for the national government, ministries, agencies and local governments to progressively include competition policy principles in their policy-making and regulatory activity.

b) Competition Law and IPR

141. In contrast with many transition and developing countries, China has not adopted yet a general competition law; several drafts have been submitted though to the State Council for consideration. Chapter 12 recommends the enactment of a general competition law. This indeed would provide a clear regulatory basis for combating regional protectionism and other ‘monopolistic’ conduct by enterprises and local governments. As mentioned previously, such practices are indeed obstructing economic integration and thus affect development.

142. In the past two decades China has adopted a set of IPR laws and regulations that are today basically in conformity with international practice and standards. As mentioned previously, the main subsisting problem with the overall regulatory framework is the lack of transparency at the local level. There has been a clear shift in approach to this issue, as the protection of intellectual rights is now understood as not only important for foreign investment and technology transfer, but also to promote Chinese innovation, and thereby to ensure China’s future competitiveness. Chapter 14 describes in detail the relatively comprehensive IPR administration and judicial frameworks that have also gradually taken shape.

143. Yet, as described and analysed in Chapter 14, enforcement is problematic as IPR infringement remains a widespread problem. A report published by the State Council Development Research Centre estimates that the value of counterfeited goods in market circulation in 2001 was between 19 and 24 billion US$ -- an amount comparable to the GDP of Tunisia.

144. Underlying causes seem to be mainly of two types. The complexity of the administrative enforcement channel and its organisational and financial structure affect its effectiveness. In particular, local administrative entities in charge of enforcement are dependent on the local government through their budget and carrier management of the staff. The vertical line of authority comes after the horizontal links to local governments, which are not always in practice strictly adhering to the policy of IPR protection announced at the national level. At the same time, several factors contribute to weaken the judicial channel of enforcement: weak sanctions, conditions to launch a criminal suit, and lack of capacity and independence of the judiciary. In light of this analysis and of the experience of OECD countries, enforcement campaigns don't seem to be a fully appropriate answer to the problem of IPR infringement. It seems necessary to develop a multi-dimension strategy, which would include a reorganisation of the administrative enforcement channel, as well as an increased participation of non-governmental actors in policy-making and implementation (cf Chapter 14).

IV.3 - SASAC, Regulatory Commissions and Corporate Governance

145. Recent reform efforts show that Chinese leaders are aware of the need to reform the governance framework of sectors in which State intervention remains high. Indeed, to take the example of the banking sector, it has become clear that injecting funds into the banks would not help repair their balance sheets if the basic framework inside which they operate was not reformed. In the past years, measures have been taken to harden budget constraints and increase managerial autonomy for companies used by the State for public policies (SOEs in general, public utilities) and for financial institutions, in order to avoid destabilising systemic crises.

146. In addition to SASAC, several ad hoc regulatory commissions have been created: the China Securities Regulatory Commission, the China Insurance Regulatory Commission and the China Banking
Regulatory Commission (CBRC). As described in Chapter 13, the CBRC was created in 2003, overtaking the responsibility of banking supervision from the People's Bank of China, to separate supervisory functions from that of arbitrator of distribution of credit. At different pace from one sector to the other, reforms have also taken place in public utilities sector. The State Electricity Regulatory Commission (SERC) has been set up recently to promote the development of a regional electricity market. As for other network industries (Cf. Chapter 3), their reform has accelerated since the late 1990s, in response to a rapidly increasing demand and to fulfil WTO commitments. In the sectors of gas, rail and to a lesser extent telecommunication, reforms have not modified significantly the institutional framework in place.

147. Instrumental to the success of the reform of state owned assets, of further capital market development and of the effective regulation of public utilities and the financial sector, is the challenge of the improvement of corporate governance in general and of listed companies in particular. China has introduced laws, regulations and codes for better corporate governance that are today comparable with those in some developed countries.

148. If on both fronts, i.e. overall institutional architecture and corporate governance rules, important steps have been taken that go in the right direction (cf. Chapters 2, 3 and 13), problems remain that call for sustained reform efforts. To take one example, the creation of the CBRC has not been sufficient to tighten appropriately loans decisions, as reflected by the 2003 credit boom. Subsisting ties, especially at the sub-national level, between state-owned companies and line ministries or local governments have hampered the effective restructuring of these companies. In May 2004, the CCP declared that party officials would no longer be allowed to work at state-owned enterprises. This measure will certainly contribute to increase the separation of state-owned enterprises from other public entities. But in parallel, measures should be taken to fine-tune the institutional and regulatory framework for SOEs, the financial sector and public utilities.

149. A first issue is to ensure that regulatory bodies are "distant enough" from the regulatory entities, in order to clearly separate the objectives and strategy assigned to companies by the State, as a majority shareholder, contractor or guarantor of financial stability, from the management of these companies. As described in Chapter 2, the creation of SASAC has clearly contributed to shift the objective of supervision from direct intervention in enterprise management to capital oversight. Yet, as SASAC continues to be responsible for the nomination, assessment and dismissal of not only the CEO but also of senior executives, it is likely that State interferences in companies' operations will continue to take place. If, when existing, boards in SOEs may not be in a position to take on these functions immediately, the procedures through which top management will be recruited and assessed should at least be transparent and inspired by criteria of competencies.

150. A second issue is to ensure that existing regulatory bodies have enough teeth, under their capacity or through another body, to make them credible. When the CBRC was created, the operating rules and related sanctions imposed on banks were strengthened. More could be done on the side of CSRC, as described in Chapter 2.

151. Finally, a third issue is to clarify and consolidate the accountability relationship between the State and the regulatory actors. This is a necessary condition to ensure that regulatory commissions will implement duly their functions. If this process of "controlling the controllers" is transparent, it helps avoid undue interferences. Finally, a clear link with upstream authorities allows arbitrating situations in which regulatory agencies may have diverging interests, as for instance between SASAC and CSRC, in situations of initial public offering.
V - Policy Enforcement

152. The transition to a market economy loosens the framework for action set before by the national plan. An important challenge in China today is the failure to strike the right balance between empowerment of public officials and private actors to increase the efficiency of public and private action, and governability.

153. These problems, exacerbated by the huge size of the country, call for a reform of the "enforcement system" for public action: i.e. the institutional devices and the practices that ensure the enforcement of public policies.

154. This part addresses at the problem of enforcement in general, and then the problem of corruption and its fight.

V.1 - Policy Enforcement

155. Under the past regime, organisation members were under the close scrutiny of their supervisors, and organisations had cumbersome book-keeping procedures. But there were few agencies or effective procedures to control the overall functioning of public entities. China needs to develop formal systems of audit / control, tied to output delivery, and to reinforce the oversight role of the legislative (Chapters 1, 2 and 10).

156. The following table proposes in a simplified way to depict the main characteristics of the enforcement system in China before the transition, in contrast with the systems in OECD countries.

Table 2 - Enforcement systems in the Chinese planned economy in contrast with OECD countries

<table>
<thead>
<tr>
<th>Some characteristics of the enforcement system in the Chinese planned economy</th>
<th>Some characteristics of the enforcement systems in OECD countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ Central role of the Party in the State's &quot;infrastructural power&quot;: ability of the power to penetrate and coordinate society; &quot;control by proximity&quot;</td>
<td>▪ Infrastructural power based on a set of institutions - Rule of law</td>
</tr>
<tr>
<td>▪ Importance of ideologies and speeches</td>
<td>▪ Key role of external audit</td>
</tr>
<tr>
<td>▪ Crucial importance of career management</td>
<td>▪ Independent judiciary</td>
</tr>
<tr>
<td>▪ Bianzhi system</td>
<td>▪ Important role of the legislative</td>
</tr>
<tr>
<td>▪ Cumbersome book-keeping procedures for organisations, but few agencies or effective procedures to control the overall functioning of public entities</td>
<td>▪ Public scrutiny</td>
</tr>
<tr>
<td>▪ Importance of enforcement campaigns</td>
<td>▪ Rule by law</td>
</tr>
<tr>
<td>▪ Limits set by the framework and the objectives of the national plan</td>
<td>▪ Accountability built in the operating procedures and practices</td>
</tr>
<tr>
<td>▪ Key role of policy documents as vehicles of guidance for public action</td>
<td>▪ Internal audit</td>
</tr>
</tbody>
</table>
157. The chapters point to a few interesting points in relation to the issue of enforcement and the ongoing transition.

158. At this stage of development of its capital markets, public enforcement remains crucial and requires the further development of enforcement tools and capacities of regulatory bodies such as the CSRC. It would appear premature to rely too heavily on self-regulation by securities exchanges and professional associations and private sector led enforcement mechanisms.

159. The regulatory framework for policy enforcement is not always strong enough. For instance, in the case of the pollution levy system, the requirements for payments of fees are based on the administrative order rather than on the laws. This makes these regulations easily challenged by enterprises managers as lacking appropriate legal basis.

160. In the field of IPR protection, today, it is very difficult to launch a criminal lawsuit and the civil and administrative sanctions are not strong enough to dissuade infringers.

161. Secondly, the Chinese legal system is still underdeveloped and trained judges are short in supply as little education takes place. Some legal specialists point out to other inadequacies of the court system, such as judicial ignorance of the law, corruption within the judicial system, pressures of judges from local government and the CCP officials and inability of courts to enforce their own decisions.

162. Enforcement may be discretionary, influenced by local interests. The protection of local interests is a serious problem, especially in law enforcement. Authorities have accused the judiciary and procuratorate of colluding with local officials to undermine attempts to institutionalize the rule of law.

163. The Chapter on environment provides interesting developments on the issue of enforcement. The Environmental Protection Bureaus (EPBs) enforcement personnel use often discretion to determine whether they will enforce requirements strictly in a particular case and the institutional context of environmental protection in China leaves EPBs with little choice. They must exercise discretion in enforcement in order to use their limited resources effectively and gain local government support for their actions. EPB have little choice of taking enforcement steps opposed by local leaders or powerful agencies.

164. The approach applied in China is considered as “pragmatic” enforcement, an approach in which the choice of enforcement action has more to do with the particular case at hand than with a rigid attachment to insisting on strict compliance with environmental rules. Pragmatism is reflected in EPBs reliance on “guanxi” with regulated enterprises and many EPB staff believe the way to bring most enterprises into compliance is by developing mutual understanding, providing technical and financial assistance, and negotiating reasonable compliance deadlines. Although this approach has been applied successfully in several cases the EPB staff stop short from revoking permits for violating their conditions or do not fine enterprises for irregularities to maintain harmonious relations with enterprises (guangxi). Accusing enterprises of cheating on its permits application is considered to be risky as it could lead to a “loss of face” by enterprise managers. Some EPB staff also feel that an enterprise penalised may never comply in the future.

165. Some of these steps, however, would require to be supported by the court decision but the EPB rarely use this enforcement path. There are several reasons for this. Firstly, in China parties in dispute prefer to resolve their differences using informal negotiations in which compromises are made by opposing sides in order to reach a consensus. Third parties often facilitate conflicts resolution by means of mediation and conciliation. Although legal institutions have become increasingly significant in China, but mediation

These paragraphs are borrowed from the chapter on environment.
and conciliation continue to be important, particularly in the context of environmental policy implementation. This approach comes from a Confucian tradition which emphasises moral values and moral instructions (not fear of legal sanctions) as a basis for guiding behaviour and maintaining social order. At the same time the Chinese Communist Party has long viewed the legal system as a means to implement the state policies rather than a basis for articulating and guaranteeing the rights of the citizens.

166. In early 1980 there has been increased use of courts to resolve disputes, particularly in the economic field. Notwithstanding the rising importance of the legal system, most conflicts related to environmental protection are settled without going to courts. There are several reasons for this: most EPBs want to avoid the costs of gathering data needed to support a legally convincing arguments; many EPBs lack staff with legal training; vaguely drafted statutes often makes it difficult to allocate responsibility and liability. In addition, EPBs know that the traditional use of negotiation to settle disputes with enterprises is more likely to preserve their “guanxi” with enterprises and going to court will place severe constraints on the future relations between the sides of the conflict.

167. Furthermore, even when courts are used, the letter of the law is only one of several factors considered in enforcing environmental rules. Courts decide on the cases by relying on Party policy, the views of the local government and a court’s individual sense of justice and fairness in contractual dealings. Factors as “guanxi” between EPB staff and enterprises managers, interventions by local officials, and an enterprise’s profitability often leads to outcomes that are far from those specified in environmental regulations.

168. Finally the vagueness of many Chinese environmental regulations mentioned above offers judges and environmental regulators flexibility as the key terms are often left undefined and precise targets and responsibilities are generally not specified.”

169. Stronger enforcement, however, takes place during specially arranged environmental campaigns, such as the three year “Inspection of Environmental Enforcement Campaign” which was launched by the central government. In these cases the enforcement efforts are assessed by inspection teams from SEPA and by national and provincial congresses. EPBs view environmental enforcement campaigns as opportunities to enhance their credibility with polluters and demonstrate their accomplishments to higher level officials.

V.2 - Curbing Corruption

170. Corruption is a particular feature of the transition process and the fight against corruption has become a priority on the political agenda. Former President Jiang Zemin defined “anti-corruption mechanisms” as a “major political task for the party” in his report to the 16th Congress of the Communist Party of China in November 2002. President Hu Jintao has made anti-corruption a top priority of his government, not only because of the direct damage of corruption to the economy, but also because of the indirect impact on the party's reputation.

171. Chapter 10 analyses the causes of corruption in China and discusses the measures taken by China in response. The transition from a planned economy with tight central control to a socialist market economy with decreasing traditional control and more discretionary power has generated far more opportunities for illicit enrichment and incentives to please officials in order to facilitate smooth business operations. The transition process has also created uncertainties in the legal and administrative frameworks, continuously changing legal provisions, frequent reorganisation and transformation of public institutions contributed to uncertainties in the businesses environment. Also, almost two decades of economic transition had an increasing impact on the culture of the society. The widening access to goods
and services, the changing living standards have affected peoples’ perception of values (e.g. material wealth is more and more considered as a reference for success).

172. Criminal and disciplinary sanctions are among the most commonly applied means to combat corruption worldwide. As explained in Chapter 10, this has been particularly true in China where repressive instruments have been the primary means to address the problem of corruption. Only gradually and recently, in the last half decade, more attention has been paid to preventive measures, including reviewing risks areas prone to corruption and creating conducive conditions that encourage ethical behaviour.

173. Major corruption cases have been extensively publicised in recent years by the largely state-controlled media. But corruption remains a serious problem for both businesses, particularly for foreign direct investment, and citizens. A lot remains to be done to complete a national ethics infrastructure and to ensure that it functions in an effective and consistent manner.

174. VI - Conclusions – Key Messages (tentative)

175. The introduction of market forces in the Chinese economy since 1978 allowed for an impressive economic take-off. These past 20 years of rapid economic growth have been supported by important institutional changes. In particular, important steps were taken to adapt the institutional setup to the “socialist market system”: set up of macro-control mechanisms, reform of the management of state owned enterprises, introduction of privately run companies and recently constitutional amendments that further guarantee the protection of private property, bases of an institutional framework for market forces (e.g. reform of administrative approval system). The government was restructured and streamlined to respond to new needs. The State has been decentralised, thus contributing to stimulate local initiatives for development. The tax system and the civil service have been improved and a budget system is being progressively set up. Finally, Chinese leaders have repeatedly asserted their commitment to move towards governing by law and to the rule of law.

176. China is at the same time a country in transition from a planned economy regime (important set of issues in particular in the North East), a developing country (West and Centre) and an emerging economy (Coastal regions). Needed governance reform efforts correspond to these three faces of China: further pursue the shift in institutional paradigm from one underpinning a planned economy regime to a market-based economy; strengthen governing capacity and efficiency; fine-tune the State’s intervention in regulating market forces and in delivering social services.

177. Of the broad scope of issues covered in this report, it seems that four governance problems should receive attention in priority.

178. If the decentralisation reforms highly contributed to spur rapid economic growth, it is important now to adjust the fiscal and institutional arrangements underpinning the relations across levels of government in order to reduce the existing fiscal gap, to ensure the delivery of social services and to combat local protectionism. The reform of fiscal relations across levels of government is the priority, but the institutional, managerial and regulatory dimensions of multilevel governance should not be overlooked.

179. The move from a centralised, one-block governance structure functionally organised by the production plan to a governance structure articulating line ministries, agencies, central and local level actors, non-for-profit organisations and private sector companies implies an increased importance given to the relationships between the actors of public realm, public and private. For the State, this means the capacity to guide actors without controlling them, to govern “in distance”, through regulations for private actors and through performance management for public actors.
180. The State must develop the capacity to adjudicate the sometimes contentious nature of economic market transactions. This requires setting up regulators and enforcement systems that will operate independently from pressures, requiring capacity and "embedded autonomy". It is also particularly important to establish a sound competition policy approach, which will facilitate progress on other major policy challenges: to reduce market segmentation and local protectionism, consolidate the IPR regime and further restructure the state owned enterprises and the banking sector.

181. A fourth priority in China appears to be the need to develop formal systems of audit / control and to reinforce the oversight role of the legislative.