

Chapter 1

Economic Reforms

The advance to a market economy in the People's Republic of China is among the greatest economic success stories of modern times. China's performance seems all the more impressive given the distinctive manner in which it was carried out.

This chapter summarises the enormous progress that China has made in developing the modern legal and regulatory foundation for the market economy. The seven years since China's accession to the World Trade Organisation in 2001 have been especially productive for economic reforms. New laws have gone a long way toward establishing systems for ownership, competition, and mechanisms for entry and exit comparable to those of most OECD economies. At the same time, the chapter outlines the important challenges that remain. These include further reduction in the scope of state ownership, reform of relations among central and local governments, firmer establishment of the rule of law, and strengthening of regulatory institutions and processes.

Introduction

The advance to a market economy in the People's Republic of China is among the greatest economic success stories of modern times. Since the beginning of the reform era in 1978, real GDP has grown at an average rate of 9.8%, a performance that compares favourably to the earlier extended growth spurts of Japan and Korea (Table 1.1). China has become the third-largest economy overall, the world's largest manufacturer, and its number two exporter. Rapid growth has led to equally impressive gains in living standards and other indicators of wellbeing. Per capita GDP has increased twelvefold, catapulting China into the ranks of lower-middle-income developing economies. The portion of the population living below the poverty line (by national standards) has fallen from 53% in 1978 to 8% in 2005 (Table 1.2). The gains have been widespread, if unevenly shared, among all regions and segments of the population.

Table 1.1. **China's comparative growth performance**

Average annual growth in real GDP	
China: 1978-2007	9.8
Japan: 1950-1980	7.7
Korea: 1950-1980	9.1
India: 1978-2007	5.9
Average growth in real GDP per-capita at PPP exchange rate ¹	
China: 1978-2004	11.7
Japan: 1950-1980	11.1
Korea: 1953-1983	9.5
India: 1978-2004	6.9

1. Per-capita GDP at purchasing power parity exchange rate from Penn World Tables, using that source's PPP exchange rate estimates.

Source: Asian Development Bank and Goodhart and Xu, 1996 for real GDP growth figures; real per-capita GDP figures from Heston, Summers and Aten, 2006.

China's performance seems all the more impressive given the distinctive manner in which it was carried out. Other international experiences have suggested that the partial reform and state dominance of the economy that prevailed until recently more often led to sluggish growth and slow development. Yet China's success during the first half of the reform era largely reflected the impetus created from the liberalisation of severe restrictions on the rural economy and its opening to foreign trade and investment. As this impetus began to wane by the early 1990s, China's reformers embarked on a more comprehensive programme of building the frameworks and institutions for a modern market economy. It is these reforms that succeeded in renewing the impetus to growth and driving it to new heights in this decade.

As discussed in the next section, China has made enormous progress in developing the modern legal and regulatory foundation for the market economy. The eight years since China's accession to the World Trade Organisation in 2001 have been especially productive for economic reforms. The country's private sector is now the largest in comparing major ownership segments and the most important driver of new growth. New laws have gone a long way toward establishing systems for ownership, competition, and mechanisms for

Table 1.2. **Indicators of China's development**

	1978	1990	2006
Real GDP (PPP, USD billion)			
At 1995 exchange rates and prices	145 ¹	408	2 154 ⁴
Per capital GDP (PPP, USD)	250 ⁷	2 340	5 370 ⁴
Percentage of employment in:			
Primary sector	70.5	60.1	42.6
Secondary	17.3	21.4	25.2
Tertiary	12.2	18.5	32.2
Average life expectancy at birth	67.9 ¹		73.2 ⁵
Mortality of children under 5	60 ⁷	45	24
Adult literacy rate (% of 15 years old and above)			
Female		68	87 ⁶
Male	77 ⁹	87	95 ⁶
Portion of population below poverty line: national definition ⁸	52.8 ¹	22.1	8 ⁵
Urban population as % of total	17.9	26.4	43.9
Portion of urban population with access to tap water		48	86.7
Telephones (fixed plus mobile/sets per 100 persons)		1	69 ⁴
Automobiles per 100 urban households		0.34 ³	4.32
Refrigerators per 100 urban households	6.6 ²	42.3	91.6
Highway density (km of roads per 1 000 km ²)	927	1 071	3 601
Railway density (km of rail per 10 000 km ²)	53.9	60.2	80.3
Foreign trade/GDP (merchandise exports + imports as ratio to GDP, %)	9.7	29.8	66.8 ⁴

1. Figure for 1981.

2. 1985.

3. 1999.

4. 2007.

5. 2005.

6. 2000-04 average.

7. 1980.

8. New definition of CNY 800 or below per year for rural persons and CNY 1 200 or below for urban persons.

9. Figure for 1982 for all adults, from *China Statistical Yearbook*.

Source: *China Statistical Yearbook*, 2007; Ravaillon and Chen, 2004; World Health Organisation; World Bank: *World Development Indicators*.

entry and exit comparable to those of more advanced economies. At the same time, important challenges remain, including further reduction in the scope of state ownership, reform of relations among central and local governments, firmer establishment of the rule of law, and strengthening of regulatory institutions and processes.

Box 1.1. **How economic reforms contribute to growth**

Growth in a country's per capita income can be determined by the rate of accumulation of capital relative to labour, by increases in the quality of labour and capital, and by improvements in technology, know-how, and other factors that contribute to overall productivity ("total factor productivity", or TFP) of those inputs. In the early stages of development, shifts in labour from agriculture and other lower-productivity activities to higher-productivity jobs in industry, and the adoption of technology and techniques from more advanced countries, have been important contributors to per capita income growth by increasing total factor productivity. At later stages of development, gains from sector shifts and absorption of know-how become more difficult, and other factors – in particular, productivity increases from better education and skills for the labour force ("human capital") and innovation become more important.

Box 1.1. How economic reforms contribute to growth (cont.)

Economic reform, including regulatory reform, is an important contributor to growth in aggregate and per capita income, in a wide variety of ways. Development of a well-functioning financial system encourages savings and their collection by financial institutions and markets – both of which are critical to rapid capital accumulation – and allocates those savings to the most efficient uses. Conversely, financial systems that offer inadequate or insecure returns, or are ineffective in allocating funds, cause savings to be diverted to less productive uses and thereby lower aggregate real growth.

Economic reforms also contribute to growth by improving resource allocation, the quality of factor inputs, and those inputs overall productivity (TFP). For example, integration of labour markets through removal of barriers to mobility is critical to achieving the sector shifts from low- to high-productivity sectors. Effective competition law reduces distortions in prices that lead to misallocation of resources and higher costs to consumers and businesses. Efficient labour markets that provide rewards to workers in line with their productivity foster accumulation of human capital through better education and training. Effective protection of intellectual property is critical to encouraging innovation and the diffusion of knowledge and expertise.

The gradual transition to the market and its macroeconomic consequences

At the beginning of the reform era in 1978, China's economy reflected the features of the centrally planned system initially adopted from the former Soviet Union (FSU). Virtually all prices and quantities were determined by the plan; formal markets were virtually absent. Businesses, except for the very smallest, were adjuncts of government agencies, and the financial system – mainly consisting of a single monobank, played a passive accounting role in resource allocation. All property was owned by the state (or collectives in agricultural communities) and there was virtually no mobility of labour. The most basic laws, regulations and institutions essential to a market economy were not present.

China's gradual transformation to a market economy since 1978 has been punctuated by important shifts in strategy and tactics and a number of major leaps, such as the one following Deng Xiao Ping's "southern tour" in 1992. The overall goals as well as the tactics of the strategy evolved during the reform period, and accompanied by the progressive upgrading of the official status of the private sector in the economy. The reform process has been highly pragmatic, indeed sometimes *ad hoc*. Nationwide reforms have often been based on prior experiments in one or more provinces. Reforms have slowed significantly at times when major problems were encountered, but the basic direction of reforms has been maintained.

A mutually reinforcing relationship between macroeconomic performance and economic reforms ("virtuous circle") has been a key driving force in the overall reform process for most of the past three decades. For example, the spurt in real growth following the initial agricultural reforms helped to ensure the success of policies allowing the emergence of township and village enterprises (TVEs). When, as in the late 1990s, structural problems become a drag on real growth, the authorities' persistence with necessary reforms succeeded in re-establishing the virtuous circle.

Partly because the transition has been gradual, a number of features of the central planning era continue to influence economic policies. The property rights regime has been greatly clarified but significant restrictions and some ambiguity remain, especially with respect to land and the sale of assets of central government-owned enterprises. The embedding of Party officials and structures in state-owned business enterprises and government agencies, based on the nomenklatura system first introduced in the FSU and adopted in China at the beginning of the central planning era, has persisted and is complicating reforms in a number of areas. The segmentation between the rural and urban economies that was reinforced during the pre-reform era is only gradually breaking down.

The geographic dispersal of industry, along with decentralisation of policy implementation (which contrasts with the centralisation characteristic of the FSU), has had a particularly profound impact on the economic reform process. Industry was deliberately dispersed for security reasons during the pre-reform era and in the early 1970s local governments were given formal ownership and responsibility for 98% of state-owned enterprises¹ (Goodhart and Xu, 1996). This, along with the extensive decentralisation of policy implementation, has continued to give local governments a large amount of effective autonomy even though China is constitutionally a unitary state. This local autonomy, because of the latitude it afforded for policy experimentation, has been helpful to reform at certain times, but it has also been a significant obstacle to reform implementation in a number of important areas.

Growth from initial agriculture reforms and emergence of the non-state sector

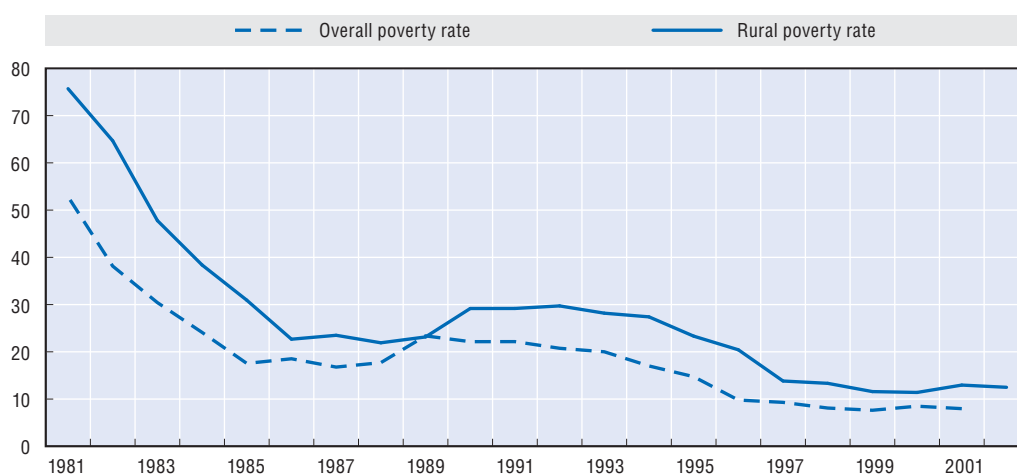
The first half of the reform period, from 1978 to the early 1990s, was marked by the gradual freeing of prices and economic decisions from the central plan, a process that has been characterised as “growing out of the plan” (Naughton, 1995). Although there was only limited formal legal and institutional development, the development of markets, emergence of the non-state business sector, and opening to foreign trade and investment laid the basis for the institutional reforms that came later.

The initial impetus to growth came in 1978-79 with the raising of agricultural prices and establishment of the household responsibility system. This system restored individual farming and allowed households to sell their output above a fixed quota at the new higher price fixed by the state. The improved autonomy and incentives for farmers led to a spurt in agriculture output and productivity, which respectively grew by 7.4% and 6.6% annually over 1978-1985² (Goodhart and Xu, 1996). Sharply rising farm incomes led to a dramatic decline in poverty, which fell from 76% of the rural population in 1981 to 23% in 1985, while overall poverty fell to 17.6% from 53% over the same period (Ravaillon and Chen, 2004) (Figure 1.1). These trends had profound repercussions for the broader economy:

- Rural household savings rose from virtually zero pre-reform to reach 20% of income by the mid-1980s, and to above 30% by the early 1990s. This together with rising urban savings provided the resources for rapid capital accumulation.
- The increase in productivity reduced the labour required in agriculture, providing a large pool of workers for the emergence and expansion of the TVEs.³

The agricultural reforms began the process of market development and freeing of prices. Beginning in the early 1980s, authorities introduced a two-tier pricing system under which output above the required quota could be sold at market-based prices.⁴ A similar system was introduced for selected industrial products in the mid-1980s, as part of broader

Figure 1.1. China's poverty rate



Note: Rates are in accordance with the new Chinese definition.

Source: Ravallion and Chen, 2004.

reforms to improve the autonomy and incentives of state-owned enterprises (SOEs). As output increased more rapidly than the quota and as the system was broadened, the portion of output sold at market prices steadily increased. Nearly two-thirds of agricultural products were sold at market-based prices by 1985, and by the early 1990s administered prices had become negligible in most sectors except for some agricultural products and energy and utilities.

Spurred by the exodus of workers from agriculture and their exemption from central planning, TVEs recorded spectacular growth and in fact became the growth engine of the overall economy. TVE output grew more than fourfold between 1980 and 1985, and employment rose from 30 to 70 million, or from 9.4% to 18.8% of the rural labour force (Goodhart and Xu, 1996). Rapid growth continued into the 1990s, with employment reaching 135 million at its peak in 1996; at that point TVEs accounted for 26% of GDP.

The transfer of labour from agriculture to higher-productivity jobs in the TVEs provided a major boost to growth in total factor productivity and potential GDP (OECD, 2005a see Table 1.3). According to estimates by the OECD Secretariat, the shift of workers to TVEs was responsible for nearly two-fifths of total factor productivity growth over 1983-88, which in turn accounted for nearly half of real GDP growth. The “extensive” growth

Table 1.3. Source of real GDP growth

	1983-88	1988-1993	1993-98	1998-2003	2003
	Percentage points				
GDP	12.1	8.9	9.8	8	9.1
Employment contribution	1.5	1	0.3	0.3	0.4
Capital contribution	5	4.5	5.5	4.9	5.5
Residual factors (=TFP growth)	5.6	3.4	4.1	2.8	3.1
<i>Of which:</i>					
Sectoral change	2.2	0.8	-0.3	0.5	0.7
Education	1	0.9	0.9	1.1	0.8
Multi-factor productivity	2.4	1.7	3.4	1.3	1.6

Source: OECD Secretariat estimates from OECD, 2005b.

recorded by China during the 1980s contrasts with the greater dependence on capital formation beginning in the early 1990s.

The TVEs emergence posed a major competitive challenge to SOEs and spurred reforms to improve their incentives and ability to compete in the developing markets. Beginning in the early 1980s, the authorities began to separate SOEs from government departments and to give their managers greater autonomy in making business decisions. Incentives to operate efficiently were enhanced through bonuses based on performance and partial profit retention. The reforms were progressively broadened into the next decade as SOEs were allowed to retain an increasing portion of their profits, and output for sale at market prices and management incentives were enhanced.

Profound effects of early opening to foreign trade and investment

China's early opening to foreign trade and investment proved to be one of the most fruitful elements of its economic reforms. Compared to the growth takeoffs of Japan and Korea, China's opening occurred at an earlier stage and went further in terms of the scope allowed to foreign enterprises in the economy. The development of the export sector followed the strategy adopted by the East Asian tigers and (earlier) Korea and Japan; its growth was promoted by the integration of China's export capacity into the distribution production networks of the region.

The opening began with the establishment of the first special economic zones in Guangdong and Fujian provinces in 1979. This was followed by the proliferation throughout the country of special zones and foreign trading companies licensed to contract with domestic enterprises, mainly TVEs, to produce for export using imported inputs. Under this "ordinary" trading regime (Naughton, 2007), production for the domestic economy remained highly protected by high tariffs and quotas. In the late 1980s, a second separate trading regime was introduced by allowing foreign enterprises (only) to establish facilities in special export processing zones (EPZs) using imported inputs exempt from duties. Foreign firms' presence grew very rapidly and soon surpassed the ordinary trading regime to dominate the export trade.

Due in part to supportive exchange rate management (Box 1.2), exports expanded very rapidly under the trade opening. By the early 1990s, China's total foreign trade, measured by the sum of exports and imports to GDP, was already high for a large developing country, and continued to grow (Figure 1.2). Foreign direct investment (FDI) grew rapidly after the introduction of the EPZs and surged following Deng Xiao Ping's Southern tour in 1992 and the subsequent opening of the Pudong and other EPZs throughout the country. By the late 1990s, China had become the largest developing country recipient of FDI and the second largest among all countries.⁵ (OECD, 2002, Chapter 10)

More limited institutional development

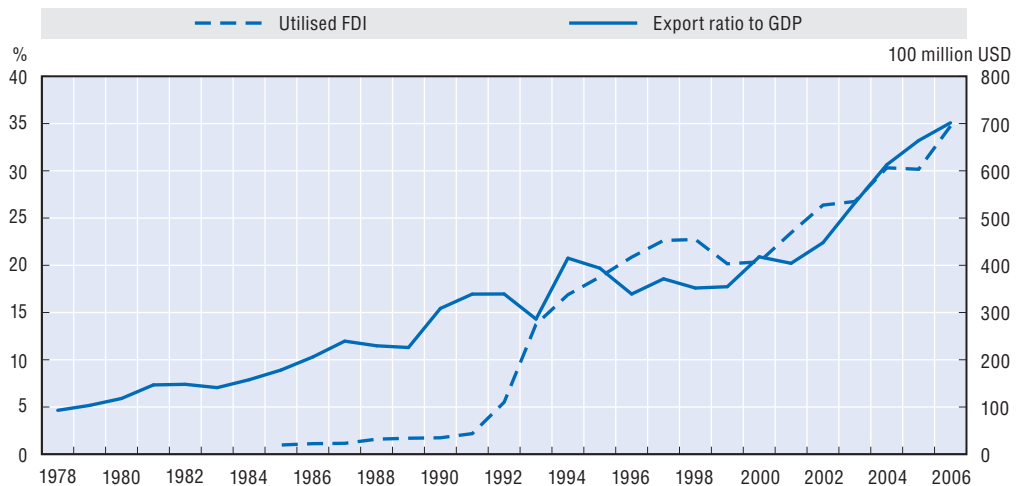
The profound changes in the real economy during the 1980s were accompanied by only limited changes in institutions or the formal legal and regulatory frameworks. TVEs operated under the legal framework of the pre-reform commune and village brigades as collectively owned enterprises. In practice, their management and organisation form was adapted to local circumstances and their support from local governments helped to secure access to credit and protection against interference from other government agencies. SOEs remained under the plan and subject to interference by their original as well as other government departments. Domestic private businesses were allowed (although enterprises

Box 1.2. Exchange rate management during the first half of reforms

China's export development was also facilitated by the flexible management and progressive liberalisation of the exchange rate regime. The official exchange rate was periodically devalued during the 1980s and first half of the 1990s to offset the effects of inflation. The introduction in 1981 of a dual exchange rate system further helped to maintain China's international competitiveness. Under this system, exporting firms were permitted to retain a portion of their foreign currency earnings for sale on regional "swap" markets to other authorised trading firms at a price determined by supply and demand. The swap rate typically was lower than the official rate and fell as it was devalued. As the portion of foreign currency earnings that could be retained increased over time, a growing portion of China's foreign trade – and by 1994, nearly all of it – came to be transacted at the market-determined swap rate. It was in 1994 that the exchange rate regime was reunified, with the official rate set at the lower swap rate prevailing just before its inception.

Opening to trade and foreign investment also spurred gradual and partial relaxation of restrictions on financial flows, especially to facilitate foreign-invested enterprises. China officially achieved current account convertibility in 1996, and seemed well on the way to capital account convertibility until the onset of the 1997 Asian Crisis prompted a shift toward more gradual liberalisation.

Figure 1.2. Exports and Foreign Direct Investment



Source: China Statistical Yearbook, 2007.

employing more than eight persons were not formally legalised until the late 1980s), but their development was constrained by ambiguities about their status and rights, especially their property rights.⁶ Formal urban labour markets were barely developed due to the lifetime employment system at SOEs, which effectively bound workers to a single employer who provided housing, education, medical and other services.⁷

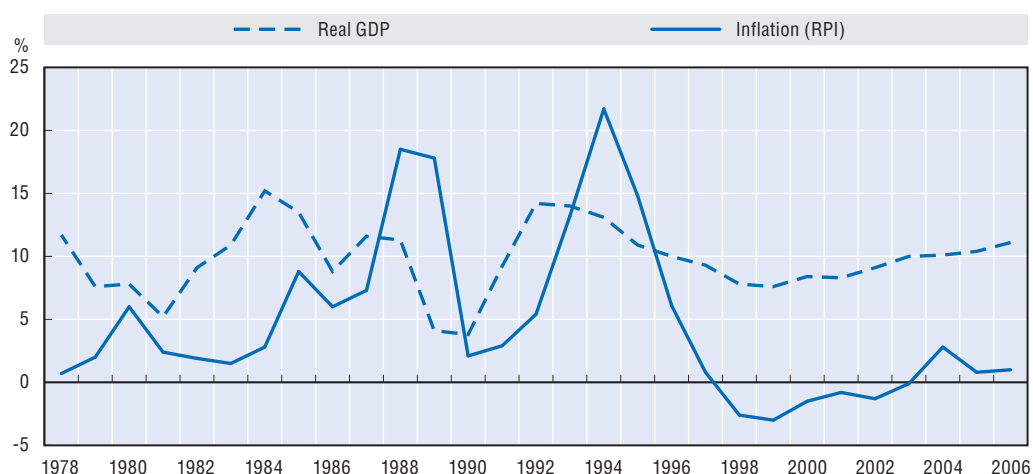
The creation in 1983 of the People's Bank of China (PBC) as the central bank and establishment of the four state-owned commercial banks (SOCBs) laid the foundation for control of money and credit through the market and provided facilities that were very successful in gathering the growing household savings. But most credit continued to be allocated on the basis of the plan at interest rates fixed by the authorities. The use of

commercial bank loans in place of fiscal outlays to fund investments that were not commercially viable created “soft budget” constraints for SOEs that blunted their incentives to operate efficiently; this contributed to their later problems and those of the banks.⁸

Incremental development contributed to other problems that became increasingly pressing in the following decade. Withdrawal of resources from rural communes following the initial agricultural reforms led to the collapse of the rural healthcare network that the communes had supported. The collapse initiated a progressive deterioration in rural healthcare access and quality. The favourable position given to foreign firms and, in effect, non-state firms in the export sector limited the incentives and ability of SOEs, particularly larger firms, to develop export markets (Naughton, 2007). The concentration of export development and FDI in coastal provinces reinforced growing inequality of development between the coastal and interior provinces. TVE development also occurred mainly in coastal provinces, due in part to the closer proximity of rural areas to urban markets, while industry in interior provinces continued to be overwhelmingly dominated by SOEs.

Institutional limitations were also manifest in three successive demand-driven business cycles during the 1980s, with peaks in 1980, 1985, and 1988⁹ (Oppers, 1997). Mindful of the ravages of high inflation during the Nationalist era, authorities acted quickly in each case to tighten credit and raise interest rates. That led to a marked but short reduction in output growth and fairly rapid ebbing of inflation pressures (Figure 1.3). The rapid containment of inflation prevented inflation expectations from becoming embedded, and avoided the financial repression that has afflicted other developing countries with chronic inflation since real interest rates became negative only for short periods.¹⁰

Figure 1.3. **GDP growth and inflation**



1. RPI is the retail price index.

Source: China Statistical Yearbook, 2007.

The difficulty in restraining demand upswings during these cycles was largely attributable to the imperfect control of aggregate credit by the central authorities. Local branches of the People’s Bank of China and the SOCBs, prodded by local governments to whom they were partly subject, had strong incentives to provide credit to support the growth of local industry. Real interest rates tended to fall during the upturns as the

administered lending rates lagged behind the rise in inflation, further fuelling the boom in investment. The still-limited profit orientation and capabilities of enterprises, particularly SOEs, aggravated the tendency toward overheating.

The fiscal system also lagged behind the transformation of the real economy, and came under growing strain into the mid-1990s. Reforms over 1980-83 introduced explicit corporate income and other taxes to replace the previous profit remittances from SOEs that had been the main basis of government revenues in the pre-reform era (OECD, 2002, Chapter 20). Taxes were explicitly shared: the sub-national governments assigned the major share of taxes on TVEs and other (domestic) non-state enterprises, while taxes on central government-owned SOEs were assigned to the central government and became its main revenue source. Tax rates and other rules were determined by the central government but tax collection was carried out by sub-national branches of the Ministry of Taxation, which in practice were subject to the influence of local authorities.

Largely because of the much slower growth of the central government tax base compared to that of lower levels, the share of the central government in overall tax revenues fell steadily during the 1980s and early 1990s. The introduction of fiscal contracting in 1988, under which provincial governments and some municipal governments were permitted to retain a portion of the increase in revenues in their jurisdiction above a fixed percentage of a specified base, contributed to this trend by giving local governments incentives to understate revenues to boost their retention of future increases (OECD, 2006). By 1993 the central government's share of total revenues had fallen to just above 20% of the total, an exceptionally low level by international standards. The central government's capacity to foster development of the economy declined as its revenue base shrunk.

The major tax reform introduced in 1994 largely succeeded in restoring the central government's revenue base and improving its elasticity with respect to economic activity. The new tax sharing arrangements immediately boosted its share of total tax revenue to 40%, where it has largely remained since.¹¹ However, the reforms left the assignment of revenues largely unchanged, and this – together with the divergences in growth among regions and between rural and urban areas – created growing strains and largely unresolved strains on sub-national governments that are discussed further below.

Waning impetus in the early 1990s

By the early 1990s, China's economy had made remarkable progress under the "growing out of the plan" strategy. Living standards throughout the country were much higher than before reforms began, and were rapidly rising further. Market forces had largely replaced central planning in most of the economy and the non-state sector was overtaking the state sector in its contribution to GDP and employment.

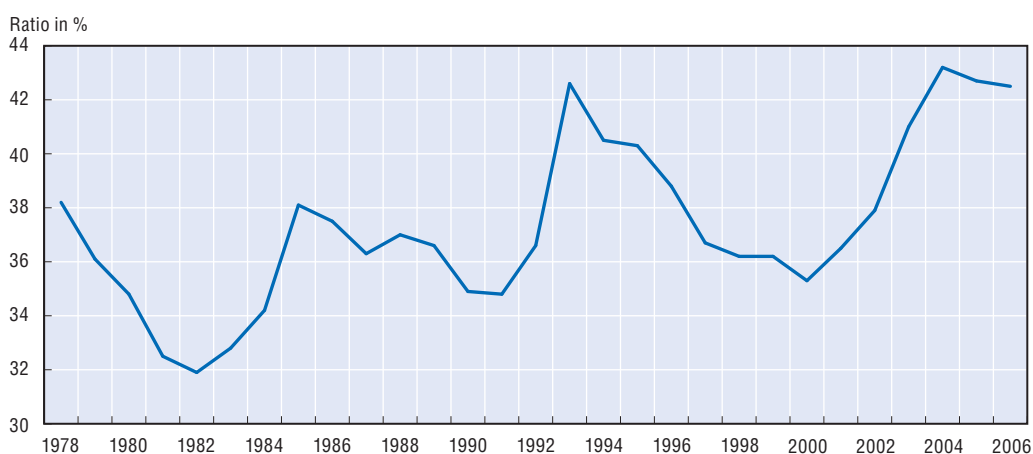
Nevertheless, strains and imbalances arising from the strategy were becoming significant obstacles to further development. The economy had become increasingly fragmented, with the business sector divided into four segments: SOEs dominating heavy industry and utilities; collectively owned TVEs focusing on labour-intensive products and export assembly; foreign-invested enterprises (FIEs) mainly confined to the export sector; and privately owned domestic companies of generally very small size. These segments operated under distinct and often very different legal and regulatory rules. Labour markets were segmented, not only between rural and urban areas but also between the formal, SOE

dominated, city sector and informal sector. Growth was becoming more dependent on capital formation as fragmentation constrained the further ability of the economy to raise productivity through sectoral shifts.¹²

Weaknesses in the competitive incentives and ability of SOEs and to a lesser extent those of TVEs, along with severe deficiencies in credit allocation by banks, were also becoming increasingly apparent in performances. By the early 1990s SOE profit rates had already fallen to levels that were low by international standards. SOE employment growth slowed to an annual rate of 1.7% between 1990 and 1995, from 2.8% over the prior five years. Lax lending standards and poor internal controls of banks, pressure from central and local governments to lend to SOEs and TVEs under their control, and lack of mechanisms to compel repayment all drove business debt accumulation to precarious levels. By the early 1990s the debt had risen to nearly twice the equity of an average SOE, while TVEs' debt ratios were even greater. Such leverage was in some cases as high as that seen in other East Asian economies before the 1997 crisis.

The severe overheating that developed during the 1991-95 economic expansion, which brought inflation from low single digits in 1990 to above 20% in 1994, underscored the continued institutional weakness in macroeconomic control instruments, and left an even more weakened business sector in its wake. The expansion was fuelled by a massive investment boom, reflected in a surge in the ratio of investment to GDP to 42%, its highest level so far during the reform period (Figure 1.4). Local SOEs undertook massive investments to try to buttress their position against the growing inroads of the non-state sector, and were encouraged by local governments seeking to support employment and boost revenues. Central authorities virtually lost control of aggregate credit as local governments successfully pressured local branches of the major banks to lend to support the investment. The investment boom again illustrated the soft budget constraints faced by SOEs; the incentives for expansion with inadequate consideration of diminished future profits resulting from local government backing for TVEs; and the weaknesses in internal management and governance of both groups of enterprises.

Figure 1.4. **Gross investment ratio**



1. Gross fixed capital formation/GDP.

As in China's past booms, the authorities acted fairly promptly to reassert control over credit once inflation became evident. At first, the economic slowdown was mild compared

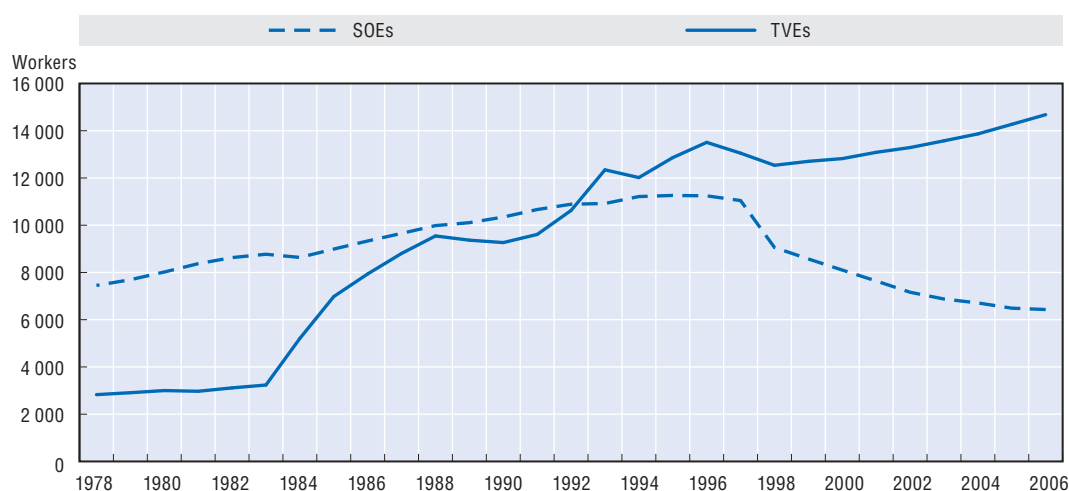
to earlier cycles and China's growth remained remarkably robust in the immediate aftermath of the 1997 Asian crisis. However, it soon became apparent that the seemingly favourable macroeconomic performance was masking serious and growing economic imbalances. The 1991-95 boom resulted in an extensive overhang of excessive or unproductive capital throughout industry. By the late 1990s, the majority of China's industries were reporting excess capacity, a condition that persisted into the following decade. SOEs were further burdened by very high inventory levels of goods that they were unable to sell due to poor quality or other defects (OECD, 2000).

The economic boom masked a serious deterioration in financial conditions of the SOEs and rising problem loans of the banking system that were apparent in the aftermath but which were well under way by the early 1990s. Nearly 30% of SOEs (and 20% of all industrial firms) were experiencing net losses by 1994, and the ratio rose further in the second half of the decade to 50% by 1998 (OECD, 2000). A substantial portion of the TVE sector had also become loss-making by the late 1990s (Naughton, 2007). The problems of the SOEs were not simply cyclical but reflected extensive inefficiency in their plant and equipment, incoherent organisation, and the burden of their provision of housing and social services to their workers. SOE workforces were bloated by excess workers amounting to as much as one-third of the total workforce (OECD, 2000).

Although China's limited accounting and loan classification masked the problems initially, the severe deterioration in bank loan quality arising from the problems of the SOEs was apparent by the mid-1990s. Reported non-performing loans (NPLs) reached 27% of total loans for the four SOCBs by 2001, and the actual figure was probably much higher (OECD, 2002, Chapter 7; Lardy, 1998).¹³ The deterioration went well beyond the SOCBs, and indicated that the problem was not simply due to their troubles. NPLs for the joint-stock commercial banks and urban credit co-operatives, which were more focused on non-state enterprises than the SOCBs, also rose markedly. The rural credit co-operatives ran into even more serious problems, with estimated NPLs of nearly 40% of their total loans (OECD, 2005b). By the close of the decade, China's banking system was effectively insolvent by the standards applied in other countries.

The macroeconomic economic consequences of these problems became increasingly evident in the late 1990s. Real GDP growth declined steadily after 1994, dropping to below 8% in 1998-99.¹⁴ By 1998, inflation had given way to deflation and the retail price index continued to fall through 2002 (Figure 1.3).

The severity of the deterioration in macroeconomic performance is most evident in the employment figures. SOE employment began to fall in the mid-1990s and its decline accelerated sharply beginning in 1999, when the programme to shed excess labour began (Figure 1.5). According to the official figures, which are based on registered workers who accounted for only part of the urban workforce, the urban unemployment rate rose above 3% in 1997 and reached 4% in 2002. However, outside estimates, based on surveys and other information, suggest that the true rate was probably above 10% by the end of the 1990s (Giles et al., 2005). Employment in the TVE sector also slowed considerably in the latter half of the decade. As a result of these trends, the shift of workers from agriculture to industry slowed sharply, leading to a further drop in productivity growth from this source. The resulting slackness in the rural labour market led to increasing migration to the informal sector in urban areas and a growing population of "floating workers"; by 2003 these were estimated to number 140 million, or 30% of the rural workforce (*Peoples' Daily*, 2005).

Figure 1.5. **Employment**

Source: China Statistical Yearbook.

Building the legal and institutional underpinnings

The strains arising from *ad hoc* development prompted a fundamental shift in the development strategy beginning in the early 1990s. As with the earlier phase, the process was initially limited, experimental and at times tentative, and met with mixed success; but it became progressively more coherent and far-reaching. The new paradigm focused on building the legal, regulatory and institutional underpinnings for a market economy in which businesses, regardless of their form of ownership, could compete on comparable terms. Regulatory and other reforms addressing the economy as a whole, rather than individual sectors or business segments, became increasingly central, particularly after the entry into WTO in 2001. The process has entailed reorganisation of the government's regulatory functions and establishment of new regulatory institutions.

For the remainder of the 1990s, reforms focused on reducing the scope of the SOE sector, on improving the capacity of SOEs and other businesses to operate as commercial entities, and on developing financial institutions and markets with the incentives and ability to allocate credit efficiently. In order to accomplish these objectives, authorities faced major challenges in dealing with the dire financial conditions of much of the SOE and banking sectors. Resolution of these problems, along with the demands implied by China's preparation for WTO accession in 2001, spurred broader reforms during the present decade to bankruptcy law, the pension system, protection of property rights and competition law and policy, as well as initial work to reform migration policy. Improved regulatory institutions and practices to manage reforms in a rapidly changing economy have become increasingly necessary, and a major theme of the overall reform process.

Following the enactment of China's first Anti-Unfair Competition law in 1993, three landmark laws came into force in 1995 that marked a key step toward developing a formal and coherent legal framework for further development of the market economy. The Company Law authorised the formation of limited liability and joint-stock companies similar in character to those found in other countries, and established their legal rights. The Law also mandated governance mechanisms for joint-stock companies, including boards of directors and supervisors, and defined in broad terms their responsibilities and rights. Although mainly intended to facilitate the conversion SOEs into commercial

businesses, the Company Law provided an improved if still incomplete legal framework for private sector development. The Labour Law gave employers greater flexibility in setting wages and provided for formal contracts between employers and workers. The new Commercial Banking Law provided the legal mandate for the SOCBs to operate as profit-making commercial institutions and in principle transferred their prior obligations for making commercially non-viable “policy loans” to the four newly created policy banks.¹⁵

Extensive SOE reform

Beginning in the mid-1990s, authorities began a comprehensive overhaul of the SOE sector, based on three objectives:

- Wholesale divestment, mainly through effective privatisation of small and medium-sized state firms owned by local governments (“grasping the largest while letting go the smaller”).¹⁶ The goal was to reduce the SOE sector to the largest, mostly central government-owned, businesses concentrated in a limited number of “strategic” sectors.
- Extensive restructuring of retained SOEs, including reduction of their workforces to economically appropriate levels and divestment of the very expensive social services provided to employees, including housing.
- Conversion of remaining SOEs into corporate legal entities operating as profit-maximising commercial businesses and endowed with effective governance structures. Remaining SOEs were to be gradually prepared for stock market listing as a means of strengthening their governance and to improve their capital base. State asset management companies were to be formed to exercise the state’s ownership interests in the remaining SOEs and separate the ownership from the other regulatory functions of the state. These reforms have been and continue to be at the core of efforts to establish an efficient SOE sector that can compete on a level playing field with domestic and foreign businesses.

Divestment of the SME SOEs proved to be the easiest of the objectives to achieve. Local governments, whose financial positions had come under pressure after the 1994 tax reforms, actively promoted transfer of their SOEs to non-state owners in order to escape the burdens posed by their losses and bloated workforces. Many firms were simply closed and a large fraction of the others were sold to managers or other insiders, often at very low prices. The process slowed temporarily in 1998 when the central government sought to crack down on abuses and deal with the disruptions that inevitably attended such a radical change. Shortly after, however, the process resumed. TVEs were also transformed, with many converted into joint-stock collectives still formally owned by their workers but in practice usually controlled by their managers. Over time, most of these became effectively privately controlled, although many continued to register as collectives (“red hats”) as a hedge against a possible reversal in government policies.

By early in the next decade, the business landscape had been transformed. The number of SOEs fell by 60% between 1995 and 2001.¹⁷ Privatisation of SME SOEs and collectives along with the improved legal/regulatory environment for private business and continued strong growth of FIEs led to a spectacular explosion of the private sector. By 2001, when China became a WTO member, the private sector, including foreign invested enterprises, had surpassed the public sector in contributing to real GDP: it accounted for nearly 55.5% of total output and 51.8% of the non-farm sector, compared to the 35.7% and 37.1%, respectively, contributed by SOEs. Domestic private enterprises had come to surpass

foreign-invested businesses in the private sector. The private sector was most predominant in industry, and dominant in export and labour-intensive industries, while the state-controlled firms remained dominant mainly in extraction, public utilities and network industries, and in financial services.

The letting go of SME SOEs was accompanied by a difficult but ultimately extensive central government effort to restructure the remainder. The traditional lifetime job guarantee system came to an abrupt end beginning in 1998 with a massive effort to reduce excess SOE workers. Nearly 45 million SOE workers – nearly one-third of total SOE employment prior to the reform – were “let go” over the next five years, most into employment centres (*xiagang*) providing temporary income support along with retraining and assistance in finding jobs. Ancillary units of the SOEs providing health, education and other services were gradually divested and converted (often with initial financial aid) into separate entities. The resulting reduction in financial burdens on SOEs were only slowly manifest, in part because they were required to supply one-third of the outlays to the re-employment centres (and often more, as local governments were often unable to supply their portion of the support and shifted the burden to local SOEs). However, the benefits became progressively larger over time as workers left the re-employment centres.

SOE downsizing and privatisation became major catalysts to the broader reforms needed to further develop the private economy. Reforms to allow individuals to acquire ownership rights to their residence, which began in the early 1990s and gained further momentum with SOE reforms, led to the development of urban housing markets and sparked a boom in spending on household-related items that helped support real growth. Legal ambiguities over claims on assets of failed or closed SOEs, unpaid taxes, and obligations to pension and other social welfare funds became important impediments to restructuring during the latter 1990s, but underscored the need for the modernised bankruptcy law that emerged in the following decade. The surge in laid-off workers increased the urgency of developing a system of unemployment and other welfare benefits and a pension system.

Efforts to improve SOEs efficiency and reform their governance proved to be the most difficult of tasks. Reforms to reorganise, consolidate, and merge SOE operations to create more commercially viable entities were hampered into the next decade by local protectionism, conflicts among government agency stakeholders, and in some cases industrial policies aimed at promoting national champions. The legal and regulatory underpinning for market-based mergers and acquisitions did not begin to develop until the next decade, and then only incompletely.

Conversion of SOEs into corporate entities also progressed slowly at first, although it gained momentum after China’s entry into the WTO. Less than half of the SOEs had been incorporated by 2003, and many of those had not fully established the governance structures mandated by the Company Law (Naughton, 2007). Initial efforts to reform state oversight of SOEs through the creation of local asset management companies charged with exercising the government’s ownership function had disappointing results. Most of these companies were organised along industrial lines and continued to be heavily involved in industrial policy and other regulation rather than exclusively focused on ownership oversight. Their efforts to restructure the companies under their tutelage were hampered by conflicts with other government agencies and other obstacles mentioned above.

The mixed success of initial reforms to recapitalise banks

Reforms began in the mid-1990s to restore the major banks to financial solvency while converting them into profit-making institutions whose lending would be based on strict commercial criteria. Following mandates specified in the 1995 Commercial Banking Law, the authorities greatly tightened bank loan standards – making individual loan officers accountable for loans that became non-performing – and began to introduce a new classification system based on international standards.¹⁸ A plan was developed to convert the SOCBs into joint-stock companies, followed by listing on the stock markets.

The authorities began providing financial assistance to banks later in the decade, beginning with capital injections into the SOCBs and a number of ailing joint-stock banks. This was followed in 1999 by the transfer of CNY 1.4 trillion of SOCB non-performing loans – an amount thought to have originated before 1996 – to four newly formed bank asset management companies charged with working off the assets. The SOCBs were left with responsibility for the remaining NPLs, which turned out to be much higher than originally estimated by the authorities.¹⁹

The 1990s banking reforms did result in a significant improvement in the financial conditions of the joint-stock commercial banks, which were in much better condition than the SOCBs and had been commercially oriented since earlier in the decade. The reforms also laid the foundation for further improvements in loan assessment, classification and risk control by the SOCBs. However, their very low profitability, along with restrictions on their ability to write off loans imposed by the Ministry of Finance, prevented the SOCBs from appreciably reducing their NPLs over the next four years (OECD, 2002, Chapter 7). Moreover, the continued large NPLs risked interfering with other reforms, since banks with no capital of their own to lose have limited incentives to maximise profits or contain risk. Faced with intractably high NPLs and under strong pressure from the regulatory authorities to avoid new bad loans, SOCBs, and to a lesser extent other banks, became very conservative in their lending policies. The result was a slowdown in aggregate lending growth and a credit crunch for smaller and medium-sized SOEs that had been or were about to be privatised and now faced loss of their local government backing as a result.

Beginning in 2003, a more decisive strategy to resolve the NPL problem was instituted under the aegis of the newly established China Bank Regulatory Commission (CBRC). The China Construction Bank and Bank of China, which had made most progress on prior reforms, were each given a capital injection of USD 22.5 billion from the central government, and the bulk of their NPLs were transferred to their corresponding Asset Management Companies (AMCs). A similar operation, involving a capital injection of USD 45 billion, was carried out for the Industrial and Commercial Bank of China in 2005. Capital was subsequently further raised by sales of subordinated debt and listing on the Hong Kong stock exchange of the three banks. These actions, together with strong economic growth, have led to a dramatic improvement in the banks' financial conditions and provided a much firmer foundation for their fundamental reform.

The priorities of inequality and sustainable development

The deterioration in SOE performance and overall slowdown in job growth accentuated concerns about growing income inequality that had been muted when growth was more robust and most people were experiencing rapidly rising living standards. Overall income inequality, measured by the GINI coefficient, rose fairly steadily beginning

in the latter half of the 1980s; by early in this decade it had exceeded that found in most other Asian emerging economies, and was approaching that found in major Latin American countries. Much of the inequality among regions reflected the growing gap between rural and urban incomes (see Figure 1.1), although differences among urban areas on the coast and in the provinces were also sizeable. Underlying the income inequality were substantial and increasing divergences in development between coastal and interior regions that had been accentuated by economic reforms. Compared to coastal provinces, the interior provinces – particularly those in the west – are more dependent on SOEs; have much less developed non-state and (particularly) private sectors; are less involved in foreign trade, especially in foreign direct investment; and are relatively poor in transportation and other infrastructure. Interior regions have also suffered most from the growing gap between expenditure mandates and fiscal resources of local governments.

To address the regional inequalities, the government introduced in 1999 an ambitious programme for Western Economic Development. The programme emphasised infrastructure development and involved tax preferences and substantial transfers of funds from the central government to western provinces. Several other policies were adopted subsequently to support rural living standards, including the abolition of a number of agricultural taxes and increased central government transfers to local governments to support education. These measures constitute the beginning of a regional development strategy, but much more needs to be done on a broader front.

Healthcare became an increasing policy concern during the 1990s (OECD, 2008b). The downsizing of SOEs extended the downward spiral in healthcare coverage and access into the cities, as workers in the growing informal sector typically lacked health insurance. By 2005, only 29% of the overall population – 7% of the rural population and 49% of the urban population – were covered by formal health insurance. Government spending on healthcare fell steadily, both in relation to GDP and in relation to total government expenditures, as local governments, which are primarily responsible for public health, cut back on health outlays to meet staff payrolls and other needs. By early in this decade, the share of overall healthcare spending in the economy contributed by the government was lower than in most OECD countries. The corresponding dependence on private healthcare spending reflected large disparities in access among income groups.

Decreasing access has been accompanied by increasing inefficiency and rising costs (OECD, 2008b). Market reforms introduced in the 1980s to decentralise provision, increase the autonomy of provider managements, and establish fee-for-service compensation backfired because they failed to address the adverse selection, limited information and other market failures inherent in healthcare markets. Government reforms since then have focused on cost containment, based on an extensive official “catalogue” of medicines, procedures and services, and their maximum prices. However, the controls have encouraged substitution of higher-cost remedies for equally effective lower-cost ones.

Due in large part to earlier public health improvements, China still compares relatively favourably to other developing countries in terms of infant survival, life expectancy and other indicators. However, much of the improvement occurred during the pre-reform and early reform period, and the gains since then have been modest. Inequality in access has produced substantial disparities in health outcomes. Some evidence suggests that life expectancy for individuals in the lower-income group is significantly less than that of those in the highest income group (OECD, 2006). The declining contribution of the

government to healthcare and rising costs has been particularly detrimental to preventive care and efforts to contain disease outbreaks, since these activities offer relatively low profits to providers. The 2003 SARS outbreak underscored the deterioration in the healthcare system, which was further highlighted by the reluctance of afflicted patients to go to hospitals for fear of incurring unaffordable bills.

As has occurred in other developing economies, China's rapid growth has led to increasingly acute environmental problems. Dependence on coal in power generation and the proliferation of automobiles in urban areas have resulted in exceptionally severe air pollution. By 2000, 16 of the 20 most polluted cities in the world were located in China. One-third of the country's water basins are classified as heavily polluted, and only one-quarter of the water flowing in urban areas is potable (OECD, 2005b). Water pollution has been aggravated by intensive use of fertilisers in agriculture. Prolonged drought in the north of China has contributed to acute water shortages. Inefficient use of water in agriculture, caused in part by protection of water-intensive grains and other crops in which China lacks a comparative advantage, contributes further to water scarcity.

Since the early 1990s, China has been making increasingly strong efforts to address environmental problems, particularly air pollution. Policies to improve the efficiency of and reduce pollution from coal-fired power plants, along with the shift in industry toward less energy-intensive activities, led to a rise in energy efficiency in industry during the 1990s. Dependence on coal dropped from 69% of total energy use in 1990 to 30% in 2004 (OECD, 2007c). The authorities have imposed increasingly strict fuel efficiency and pollution standards on automobiles. The establishment of targeted ceilings on sulphur emissions and the introduction of fees on emissions led to a decline in sulphur concentrations in urban air during the 1990s. However, considerably more needs to be done, as underscored by indications that energy efficiency has fallen during the present expansion while sulphur concentrations have begun to rise again (OECD, 2007c).

Revived growth momentum in the wake of WTO accession

By the time of China's entry into WTO in 2001, the downward cycle in real growth was coming to an end. Real GDP growth began to accelerate, rising to above 10% by 2003 and to nearly 12% in 2007. Investment picked up sharply, with gross fixed capital formation rising from a low of 32.3% of GDP in 2000 to 41% in 2003, and it has averaged nearly 43% over 2004-06 – the highest sustained level since the beginning of reforms. Overall, the current expansion is becoming the longest of the reform period. The price deflation seen in many sectors over 1998-2001 began to abate, although unlike prior cycles aggregate inflation remained moderate, in the low single digits, until recently.

WTO has been one of the factors contributing to the growth turnaround. China's exports boomed after 2001, bringing the export/GDP ratio to 35.1% by 2006 compared to 20.8% in 2000. China's ratio is well above that of the United States, Japan and other large emerging economies. FDI also picked up after entry, following the stagnation of the latter half of the 1990s: it increased by 70.6% between 2000 and 2006. The direct contributions of the export and FDI booms to growth were significant but modest; their indirect contributions, on the other hand, have been substantial.²⁰

The emergence and rapid growth of the private business sector has almost certainly been a key factor in the revival of real growth. Growing evidence indicates both that private firms are considerably more productive than state-owned firms and that their productivity

is growing more rapidly (Dougherty and Herd, 2005). The displacement of SOEs by private firms has helped to raise overall productivity in the economy directly and indirectly, by facilitating the absorption of workers from agricultural sector. Overall, the development of the private sector may be the most important factor behind the apparent acceleration in total factor productivity growth in recent years and the rise in China's potential growth rate. This increase in potential growth may explain why inflation has not surged as much as during previous growth booms.

Progress in unwinding the imbalances of the 1990s also probably played a role in the revival of real growth. SOE employment stopped declining in 2003. SOE financial performances began to revive from the very distressed levels they had reached at the end of the 1990s, with average profitability rising to levels near those of some OECD countries and with lower, though still high, debt loads. SOCBs' balance sheet conditions improved dramatically following the capital injections and transfers of bad loans to the asset management companies beginning in 2003, and the revival in economic growth has led to further substantial improvement for all banks. By the end of 2007, the NPL ratio of the SOCBs had fallen to 8% of total loans from 20.4% in 2003, while NPLs for the banking system as a whole had fallen to 6.2% of loans from just below 18% in 2003 (OECD, 2008a). Capital adequacy ratios have risen steadily. By the end of 2007, all the nationwide banks and most city commercial banks had met or exceeded the BIS-mandated minimum of 8%. Bank profitability has also recovered impressively. The severe credit crunch that began in the late 1990s also probably began to ease by 2003.

The vicious circle of real economic growth and economic reform that threatened to develop during the late 1990s has given way to a virtuous circle during the present expansion. Robust real growth is responsible for much of the considerable improvement in bank financial conditions. There have been equally impressive improvements in the performances of other segments of the financial system and in the conditions of SOEs. These improvements have facilitated implementation of existing reforms and made it easier to introduce further measures that authorities were hesitant about earlier because of concern that they might aggravate problems of weakened sectors. Authorities became more willing to spend the large amounts needed to achieve a breakthrough in financial and other reforms as the economic expansion augmented fiscal resources.

Significant strains on macroeconomic performance have emerged over the past two years, however. Inflation measured by the consumer price index began to accelerate in 2007 and peaked at 8% (year-on-year) in the first four months of 2008 (World Bank, 2008). Although sharply rising food prices were the proximate cause and CPI inflation has since fallen somewhat, core inflation and urban wage increases appeared to be accelerating, at least through 2007²¹ (World Bank, 2008). China's current account and balance-of-payments surpluses have risen steadily, reaching 11.3% and 14.0% of GDP in 2007. These exceptionally large surpluses have led many observers to conclude that China's exchange rate is seriously undervalued, and have fuelled speculative capital inflows in anticipation of a revaluation.²²

China's authorities are now facing the additional challenge of countering the downward pressures on growth from the world economic slowdown sparked by the US financial crisis. Real GDP growth (year-on-year) fell below 10% in the third quarter of 2008 for the first time since 2005, and is expected to fall further in 2009. The growth slowdown has aggravated the decline in stock prices, which have fallen by more than 50% from their

peak in October 2007. The authorities have responded rapidly to the slowdown by cutting the central bank benchmark interest rate by a cumulative 81 basis points between mid-September and the end of October; reducing banks' required reserve ratio; and most recently by announcing a large fiscal stimulus package. While the growth slowdown has temporarily eased concerns over inflation and the external imbalances, they may well re-emerge once recovery is under way. The authorities' success over the medium term in supporting non-inflationary real growth in line with potential and achieving better balance in the external accounts will be critical to sustaining the virtual circle that has benefited reforms over much of this decade.

Taking stock: Progress on reform so far and its contributions

Economic reforms have gained considerable momentum over the present decade. Legal and regulatory reforms have become increasingly prominent and supportive of the overall reform process. Many of the frameworks and institutions for effective functioning and regulation of the economy are now in place and are bringing significant benefits. Several fundamental laws that have been in preparation for years and are subject to considerable controversy finally came into effect over 2005-08. There have been major breakthroughs in financial reforms. Governing and regulatory capacities have been significantly improved by the reorganisation of the government in 2003. However, much further effort in implementing the reforms will be required before they become fully effective, and new challenges are emerging.

Well-established national product markets

The process of price liberalisation has largely been completed. Market forces now dominate in most of the economy, leading to improved resource allocation. By the middle of this decade, 87% of producer prices and 96% of retail prices were determined by market supply and demand, compared to 46% and 69% in 1991 (Table 1.4). Oil and natural gas, electricity, tobacco, and grains and fuel oils remain subject to price controls (Hope and Hu, 2005).

Table 1.4. **Portion of transactions prices determined by the market**

Percentage of transaction volume	1978	1991	1995	2003
Producer goods				
Market prices	0	46	78	87.3
State guided	0	18	6	2.7
State fixed	100	36	16	10
Retail sales				
Market prices	3	69	89	96.1
State guided	0	10	2	1.3
State fixed	97	21	9	2.6
Farm commodities				
Market prices	6	58	79	96.5
State guided	2	20	4	1.6
State fixed	93	22	17	1.9

Source: OECD, 2005b, Table 1.3 and Oppers, 1997.

Product markets are also generally well integrated, although limitations in transportation infrastructure can lead to significant price differences among regions. Changes in demand and supply conditions seem to be transmitted among China's markets

at a rate and to a degree comparable to that found in more advanced economies (Fan and Wei, 2003). Agricultural markets also seem reasonably well integrated (OECD, 2002, Chapter 1). While local protectionism has been an important barrier to movement of certain products, e.g. beverages and automobiles as well as productive factors, its importance is declining (Box 1.3).

Box 1.3. Local protectionism has been declining in importance

Protectionist practices by local governments have been a chronic obstacle to the integration of both product and factor markets. Distortions in the tax system and other aspects of central-local government relations have often given local governments the incentives and ability to protect local industries and workers. Local protectionism has been concentrated on certain products, notably tobacco, alcoholic beverages and motor vehicles, which have been important sources of local revenue, rather than generalised, and is less important in coastal provinces than interior regions, particularly those in the West (Li, Yu and Chen, 2003). Local government attempts to protect local jobs and businesses are probably partly responsible for the comparatively low portion of mergers and acquisitions that occur across provincial boundaries (OECD, 2005b).

The balance of evidence suggests that local protectionism has been a significant impediment to competition and entry in some areas but not of overriding importance (Hope and Hu, 2005). A 2003 survey of Chinese enterprises found that local protectionism continues to be an obstacle but had become less severe, due at least in part to central government efforts to suppress the practices (Li, Yu and Chen, 2003). The survey also found that local protectionist measures were becoming less explicit (i.e. carried out via administrative procedures rather than overt rules) and were changing in emphasis toward protecting local workers from competition from migrants.

Economic reforms have substantially reduced the barriers to internal capital mobility over time.²³ Commercial banks have been free since the lifting of the credit plan in 1998 to transfer funds among their branches. The development of the money market in this decade, in which virtually all financial institutions now participate, allows funds to be transferred from surplus to deficit areas. The stock and bond markets, although still developing, provide additional channels for capital to flow among regions. Overall, China's capital markets probably are better integrated than they were even in the 1990s, although they are still probably less integrated than product markets²⁴ (Boyreau-Debray and Wei, 2004). Imperfect integration does not appear to have prevented the emergence of considerable regional specialisation in industry in line with regional comparative advantage (Batisse and Poncet, 2004). Moreover, regional specialisation appears to have increased since the 1980s (Bai *et al.*, 2003), which is consistent with improved integration of capital markets.

Fragmented labour markets

China's labour markets, particularly urban labour markets, have developed substantially since the 1990s under the impetus of rural migration and as workers shed from SOEs have found alternative employment. Wages in both the informal and formal sectors are largely free from official controls. Labour markets are relatively flexible in terms

of regulatory burdens and, at least in the informal sector, in terms of the ease with which workers can be hired or discharged (World Bank, 2008).

Further development of China's labour markets is hampered by substantial barriers to mobility among segments that are only slowly coming down. Migration from rural to urban labour markets continues to be impeded by the household registration system (*hukou*), which restricts rural migrants' access to education and medical and other services in urban areas. This restriction has been relaxed somewhat in recent years, but mainly in a few of the wealthier coastal cities. Rural migration is also impeded by the land tenure system, under which migrants risk losing the use-rights to their land if they fail to farm it for an extended period. Urban labour markets are segmented between the formal sector and the informal sector, which absorbs nearly all the migrants and now employs the majority of urban workers.

Impressive progress has been made over the past decade in establishing the framework for pensions, unemployment and other social benefits (Box 1.4). However, coverage is at present largely confined to workers in the urban formal sector, while workers in the urban informal sector and rural workers are largely uncovered. Moreover, workers entitled to pensions from their employer often face loss of their accumulated benefits if they take a job in another city or province. The limited coverage and portability are important contributors to labour market segmentation.

The lack of integration of labour markets is manifest in differences in wages and productivity among markets that are large even compared to other developing and transition economies (Fleischer and Yang, 2004). Migration is extensive but the portion of migrants moving across provincial boundaries is comparatively low, a pattern which may account in part for the relatively small average size of China's cities (OECD, 2005b). The potential benefits to improving labour market integration, from improved allocation of labour and better incentives for upgrading of human capital, are substantial.

The new competition law for sustaining open and efficient markets

Competition in China's product markets is uneven. Standard indicators of concentration for the nation as whole are moderate or low by international standards. However, competition is often less in practice than the indicators suggest because of geographic restrictions on market scope imposed by limitations in transportation and other infrastructure (OECD, 2002, Chapter 12). Many industries, particularly in labour-intensive sectors, are fiercely competitive. Although private firms have entered a growing number of industries previously reserved for state firms, several industries remain entirely or partially closed to their participation, including natural resources and national defence industries. Competition is limited in other sectors where the state has more recently withdrawn exclusive control, including petroleum processing, metals, chemicals and transport. As in other countries, government regulation not infrequently has been used to limit entry or to favour some businesses over others.

As discussed in Chapter 3, there has long been a need for a comprehensive competition law to redress gaps and other weaknesses in the 1993 Anti-Unfair Competition Law (AUCL) and to address developments in the business sector that have occurred since then. In 2008, following more than a decade of consideration and extensive consultations with competition experts in the OECD and other countries, a new law (Anti-Monopoly Law, or AML) came into effect. The new law aligns China with international

Box 1.4. China's social benefits system

China began developing worker safety net and other benefits in the mid-1990s. These began with maternity and worker injury insurance, which were followed later in the decade by medical and unemployment insurance. Coverage, now limited to the urban formal sector and to individually-owned businesses on a private basis, is relatively low by international standards: less than one-sixth of the overall workforce is covered by unemployment benefits and only about 5% by worker injury or maternity benefits (OECD, 2005a, Chapter 11). Contribution rates vary across provinces within ranges set by the central government. Contributions are typically pooled at the municipal level, although the central government authorities have been encouraging pooling at the provincial level to better address funding shortages in poorer localities. Each system is administered by a separate department of the local labour bureau, and subject to the overall oversight of the Ministry of Labour and Social Security.

The current pension system framework originated with reforms beginning in 1997; these were based in part on recommendations of the World Bank. The system presently covers only formal sector urban workers. The first tier of the system comprises two mandatory elements: a basic pension financed entirely by employer contributions (now equal to about 20% of payroll), with benefits paid from current contributions ("PAYGO"); and an individual account, jointly financed in most cases by employees and employers. The basic pension is intended to provide about 35% of a (male) worker's prior salary after a minimum of 15 years of employment and retirement at age 60. Although the individual accounts are supposed to be fully funded, in practice borrowing by local governments has effectively made them PAYGO. The creation of the National Social Security Fund in 2001 was intended in part to address this problem by maintaining funds to back the first-tier pensions. The pension second tier is a voluntary employer-sponsored plan to provide retirement annuities and is concentrated among private enterprises. The Enterprise Annuity Funds holding these contributions are becoming important institutional investors (OECD, 2008a).

The current pension system is characterised by relatively low coverage (less than 50% of urban workers) and very generous benefits paid to a limited fraction of retirees, which results in relatively high contribution rates (Salditt, Whitford and Adema, 2007). The longer-term challenge is to reduce benefit and contribution rates to sustainable levels over time while gradually extending benefits, first to the whole urban workforce and then to the rural population. These reforms are especially needed given China's rapidly ageing population. Reform will involve changes not only to the pension system itself but also financial changes to improve the risk-return profile on pension savings by broadening the range of assets permitted to insurance companies, mutual funds, and other repositories for longer-term savings.

practices by providing an updated and comprehensive legal framework for combating a wide range of anti-competitive practices, including those of government agencies. It addresses anti-competitive practices by groups of firms, monopoly and abuse of position by individual firms, mergers, and – particularly important – administrative abuses by government agencies that limit competition. It provides a general framework for mergers, which was missing from the earlier law, as well as remedies against anti-competitive practices by utilities. Chapter 3 indicates that the AML is likely to be more effective in combating price fixing and other collusive practices than the earlier law.

The AML provisions on administrative abuses could turn out to be among its most important contributions, particularly if it is effectively applied in those localities where local protectionism is still a serious problem. Government agencies, including local governments and their organs, are forbidden under the law to use approval, licensing, procurement, and other regulations to favour local businesses or otherwise discriminate among businesses. Regulations or practices requiring local businesses to give local residents preference in hiring are also prohibited. As with earlier laws, the prescribed remedy is limited to administrative action, with the next higher level of the agency committing an abuse responsible for its correction. This arrangement has impeded enforcement in the past since higher-level government agencies have often been reluctant to intervene against the decisions of their lower levels in local matters. The new law attempts to address this problem by authorising the relevant competition authority to notify an agency if it receives reports of abuse.²⁵

Considerable experience with implementation, judicial interpretation, and clarification of ambiguities in a number of provisions will be required before the full effect of the new law can be assessed. A key question is how conflicts between competition considerations, other industrial policy and other official goals will be balanced. Although industrial policy has been gradually diminishing, it remains important in certain areas. The 2006 government work plan continued to call for rationalisation and consolidation in sectors with overcapacity, but achieving these goals in the past has involved agreements among firms and industry associations that could come into conflict with the new AML. Some provisions of the new law also require further implementing rules and may at some point need to be reviewed. The merger rules presently cover only foreign mergers with and acquisitions of domestic firms, and are subject to individual review and approval by the Ministry of Commerce (MOFCOM); in certain sectors they may also require review by sectoral regulatory authorities, and, where national security is involved, by the National Development and Reform Commission (NDRC). These requirements are elaborate compared to those applied in many OECD and non-OECD countries, and some international experts have expressed concerns that they may be unduly burdensome. The recent announcement of new rules lowering the threshold for anti-monopoly scrutiny of mergers or acquisitions by foreign companies with operations in China has heightened these concerns.²⁶

Assignment of responsibility for overseeing and enforcing competition raises organisational questions that are also relevant in other areas of China's regulatory policy. Enforcement authority is now divided between the State Administration for Industry and Commerce (SAIC), MOFCOM and NDRC.²⁷ This division contrasts with the more common arrangement in the OECD countries of vesting authority over competition law in a single national competition body. The Chinese arrangement takes advantage of the expertise that has been built up in the existing agencies, but has at least two important disadvantages. First, information acquired by one agency may be relevant to issues before another but may not be adequately communicated. Second, decisions concerning competition issues may be interfered with by industrial policy and other issues under the purview of the agencies. The new AML does not explicitly change the earlier division of authority but does provide for the future establishment of a state anti-monopoly commission under the State Council. Whether this body will assume the main responsibility over competition law or play only a co-ordinating role remains to be seen.

The legal foundation for further private sector development

The past decade has seen the enactment of a series of laws and other measures that have finally established private business as a legitimate and essential component of the economy, and that have provided the essential foundation for its continued rapid development. The legitimacy of private business gained constitutional sanction in 1999 with the adoption of an amendment explicitly recognising private ownership and specifying that its rights should be protected. Two further clauses added in 2004 stipulate that the state encourage, support, and guide the development of the economy and forbid encroachment on private property rights.

These reforms, and the market-opening commitments made for China's WTO entry, highlight the shift in the earlier development strategy toward reintegration of the business sector by levelling the playing field among foreign-invested, domestic private, collective, and state-owned enterprises. In 2005 the State Council took a further concrete step in this direction by issuing "guidelines on encouraging, supporting and guiding the development of the individual, private, and other non-public economic sectors". The guidelines call on local governments to allow private firm entry into all sectors opened to foreign firms under WTO, as well as some other sectors not open to foreign firms such as utilities, health, education, and national defence.

The enabling laws essential to implementing this strategy began to fall into place in the middle of this decade with the introduction of amended Company and Securities Laws in 2005. The Laws mark a key step toward establishing a modernised framework for private sector development by extending the framework of the earlier 1994 Company Law, which was designed largely to facilitate incorporation of SOEs and which subjected even small companies to the same requirements as large SOEs (Wang and Hung, 2006). The new Company Law significantly broadens the range of permissible company forms by authorising the creation of single-person-owned limited liability companies (although it maintains the relatively high minimum number of 50 shareholders required to establish a joint-stock company) and setting much-reduced minimum and uniform capital requirements for establishment.²⁸ The new law drops investment restrictions imposed by its 1994 predecessor. It specifies provisions to strengthen the corporate governance of joint-stock companies by defining the functions and responsibilities of the boards of directors and supervisors, the duties of their members, and the inclusion of independent directors. The law also strengthens protection against abuses, for example by explicitly sanctioning related party transactions, and the protection of minority shareholders.²⁹ These provisions are further strengthened for listed companies by the amended Securities Law.

The following two years recorded the adoption of two other laws essential to the business sector framework. The corporate bankruptcy law, enacted in 2006 after long internal debate and drafting and effective in June 2007, replaces the 1994 "trial law" that was designed mainly for SOEs and which has been used only sparingly because of major gaps and ambiguities (Zhang, 2006). The new law draws heavily on international best practices and applies to all companies, including foreign-invested enterprises and overseas subsidiaries of Chinese companies. It (somewhat) clarifies the conditions triggering bankruptcy, defines expanded alternatives allowed for its resolution (reorganisation, reconciliation, or liquidation), and the procedures to be used in each case. The law remedies a major prior constraint on bankruptcy proceedings under the 1994 trial law by

specifying that claims of secured creditors take precedence over unpaid employee compensation, taxes, and social insurance contributions.³⁰

The new property law adopted in 2007 defines and codifies the rights to private property and establishes equal protection of property rights of state-owned, collective and private businesses and individuals. The law defines each type of property; specifies means to enforce property rights; provides for the establishment of property registers; and broadens the range of property recognised as collateral to include inventories and business receivables. The law does not fundamentally alter the property rights regime for land but it does mark a beginning in defining use-rights to land as property rights, which in principle could allow their transfer. It also explicitly prohibits unilateral alterations of land use contracts by the legal owner for the life of the contract.³¹

Here again, considerable experience with the new laws, including judicial and administrative interpretation and clarification of their provisions, will be required before their effects are fully manifest. However, the benefits are likely to both large and broad. For example, the laws should make it easier for larger private businesses to develop, improving their productivity in sectors where optimal efficiency requires large-scale operations; to redeploy resources from failing companies to more productive uses; and to improve resource allocation and productivity through mergers and acquisitions and business alliances. The ability to use inventory and receivables as collateral should greatly improve the environment for SMEs, whose limited access to bank loans has been due in large part to their lack of collateral (OECD, 2008a).

The benefits from WTO entry

The agreement under which China entered the WTO in 2001 was one of the most comprehensive and far-reaching in the organisation's history. The agreement mandated a further reduction in tariffs in a wide range of sectors along with the conversion of quotas into tariff equivalents.³² The agricultural sector was partially opened by elimination of the state monopoly on grain trading and the conversion of quotas into tariff equivalents with a schedule for their reduction. China committed to extensive changes in laws and regulations governing entry, approval, licensing and intellectual property to improve the environment for foreign businesses. The commitments to open key domestic services, including eventual national treatment in banking and several other areas, went beyond those made by any other developing country up to that point (Greene *et al.*, 2006). In return, China received tariff reductions, quota relaxations, and other measures to increase access of its businesses to markets abroad. These included a phased abolition of the multi-fibre agreement that had severely limited Chinese (and many other developing countries) exports of textiles and their products.³³

The benefits of China's WTO entry along with the trade liberalisation that preceded it go well beyond the impressive increase in aggregate exports and FDI that has occurred since entry, and are likely to continue to be large. A recent OECD study using a computable general equilibrium model estimated that full implementation of China's WTO commitments would raise GDP by 2%, and that further liberalisation could add as much as an additional 1% (Greene *et al.*, 2006).

The quality of China's trade has been increasing in several dimensions, with rising value-added content in exports in a number of sectors, particularly electronics goods (Greene *et al.*, 2006; Molnar, 2005). In terms of their range and technology content, China's

Box 1.5. **WTO entry: Fewer costs than expected**

It was widely expected that WTO entry would impose significant losses on certain domestic sectors where foreign producers were known to be much more competitive (OECD, 2002, Chapters 1 and 4 and Annex II). Of most concern were: agriculture, especially the grain producers in the north of China who would have to compete against imports from the United States and other major producers that dominated world markets; automobiles, where the reductions in tariffs and relaxation of quotas were expected to drive many smaller Chinese producers out of business and force a massive restructuring of the industry that focused more exclusively on assembly; and in banking, where foreign banks appeared able to take a large portion of business away from the less efficient and financially weak domestic banks.

However, the costs have turned out to be much less than feared. Partly because domestic agricultural prices had fallen to near world levels on the eve of accession (OECD 2003, Chapter 1), China's grain imports have turned out to be much lower than earlier projected. The disruption to agriculture as a whole has probably also been softened by the extensive efforts to shift crops toward more competitive products, such as fruits and vegetables, that began in the run-up to WTO entry. The boom in Chinese demand for automobiles that began in the late 1990s greatly boosted sales, production, and profits of domestic producers despite a marked increase in imports. And, as noted earlier, domestic banks' financial conditions have improved greatly as a result of the strong growth in the overall economy and the reforms to remove non-performing loans and raise capital. Foreign banks' share of the market has remained quite small, although they have made more important inroads in investment banking and other sophisticated areas.

exports are becoming closer to those of more advanced countries such as Korea and Hong Kong, China (Rodrick, 2006). China has become the world's leading exporter of information and communications equipment, and its firms are moving beyond pure assembly of imported parts into processes requiring higher-skilled labour and greater technology inputs (Greene *et al.*, 2006).³⁴ While domestic reforms and government policies to encourage upgrading of China's export industries have been important factors behind the quality improvements, trade liberalisation has been a key facilitator. The opening of the services sectors has already brought tangible benefits, notably in distribution where the entry of several major international retail chains has helped to improve efficiency and lower costs in the retail sector.

Ultimately, the most profound benefits from China's WTO entry are likely to be those on the overall reform process. China's authorities have viewed WTO entry as integral to the development of a competitive market economy. The commitments to international partners solidified and improved the credibility of plans to further open domestic markets and to improve the capacity of domestic businesses to compete. The changes in laws and regulations mandated by WTO on competition, intellectual property rights protection and other areas are as essential and beneficial to domestic businesses as to foreigners.

Reforms to alleviate regulatory burdens: A mixed picture

China's system of business regulation has been emerging from the heritage of central planning, under which it was characterised by: a very large number of rules formulated and enforced by wide range of agencies with sometimes overlapping responsibilities;

differential treatment of businesses according to their role in the plan; heavy reliance on administrative discretion and at best limited transparency; and extensive decentralisation of regulatory responsibility, leading to wide differences in practices and standards among industries and regions. The regulatory system became further fragmented during much of the reform era as new rules enforced by new or expanded agencies were added. As a result, by the late 1990s, as China was preparing to enter WTO, the large costs and uncertainty imposed by the regulatory regime had become a major concern of China's foreign partners – and probably an even greater burden on the domestic business sector, particularly private businesses. Construction of a coherent and efficient regulatory regime that can promote development of the market economy has become a major priority, one that has been even greater impetus by China's WTO obligations.

Chapter 4 of this report discusses the great benefits offered by reforms in terms of improving the efficiency of business regulations and reducing their burden. Such reforms can lower costs for businesses and consumers by improving resource allocation, enhancing competition, and reducing the burdens of compliance with regulation. Higher-quality regulation also helps improve the variety and quality of products and services offered on markets. Reduction in regulatory complexity can be a powerful tool in combating corruption, since every encounter between a business and a regulator creates the opportunity to extract bribes or other favours (World Bank, 2008). In these ways, reform of business regulation is important to ensuring that the benefits from market opening are realised in improved economic performance.

China ranks very high in surveys of desirable outlets for foreign investment (MSN Network News, 2008), but mainly because of the immense potential of its large and rapidly growing market. China's ranking on international investment and business climate surveys is less favourable. Chapter 4 cites several areas of concern to OECD businesses as revealed in OECD business surveys, including discrimination, difficulty in finding out about and getting clarification on regulations, and protection of intellectual property. China has improved its rank in the World Bank "Ease of Doing Business Survey" (World Bank, 2008), rising from 92 in 2007 to 83 in the 2008 survey; but progress has been uneven (Table 1.5). China ranks particularly low in the cost of starting a business, due in part to the still-high minimum capital required; in the difficulty of getting licences and approvals (where it ranks close to the bottom); and in the cost involved in paying taxes. The investment climate varies considerably across the country, from relatively favourable in several eastern

Table 1.5. World Bank rankings on ease of doing business, 2008

	China	India	Singapore	Japan	Germany	United States
Overall rank	83	120	1	12	20	3
Starting a business	135	111	9	44	71	4
Dealing with licences	175	134	5	32	16	24
Employing workers	86	85	1	17	137	1
Registering property	39	112	13	48	47	4
Getting credit	84	36	7	13	3	7
Protecting investors	83	33	2	12	83	5
Paying taxes	168	165	2	105	67	76
Trading across borders	42	79	1	18	10	15
Contract enforcement	20	177	4	21	15	8
Closing a business	57	137	2	1	29	18

Source: World Bank, 2008.

cities to less favourable for both domestic and foreign businesses in many interior cities, particularly those in the western region (World Bank, 2006).

Successful reform of business regulation requires that several key principles be embedded in the regulations themselves and in the practices of the bodies that make and enforce them. First, formulation and implementation of regulations needs to be transparent and open to consultation and comment from those affected, and facilities for appeal against adverse rulings need to be available. Second, regulations need to be non-discriminatory in that businesses and individuals with similar characteristics are treated comparably. Third, regulation needs to be efficient: rules need to impose the least burden or restriction necessary to achieve the regulatory objective. And fourth, domestic technical standards need to be harmonised with international standards and conformity procedures streamlined so that they do not impose unnecessary costs. Achieving these objectives in China is requiring extensive changes in laws and regulations, and reform and reorganisation of regulatory responsibilities. Explicit incorporation of competition policy principles and tools into the regulatory process can help greatly in ensuring that reform is successful.

Chapter 4 describes the considerable progress that has been made in incorporating these principles into China's business regulation. For example, China has gone "a step further" than many WTO members in its efforts to improve regulatory transparency by establishing an inquiry point to provide authoritative clarification of laws and regulations affecting international trade, and in agreeing to publish all laws and regulations in at least one official WTO language as well as in Chinese. The law on government procurement adopted in 2003 prohibits unreasonable discrimination among suppliers, including foreign suppliers.

There are ongoing efforts to reduce unnecessarily burdensome or restrictive business regulations. Since WTO accession, 1 195 of 3 948 regulations requiring administrative approval have been nullified in an exercise spanning 65 departments. Two umbrella administrations have been established to spur and oversee the immense task of reforming China's technical standards regimes. China has strengthened its participation in foreign standards-setting bodies in order to facilitate the process of harmonising its standards with those prevailing internationally.

The basic foundation for improved business regulation has been established. Despite resistance in a few areas (notably foreign mergers and acquisitions), the reform process seems to be gaining momentum. Much remains to be done however, as the next section discusses. Progress has been greatest at the national level, where the central government has been the driving force, and in coastal cities such as Shanghai, where the prominence of foreign trade and investment has been a strong force driving reform of business regulation.³⁵ Reform is much less advanced in interior provinces, where it is also most crucial to development and to the reduction of regional inequalities.

A more coherent SOE framework – established, but effective?

Reforms over the past decade have significantly clarified the scope of state ownership while improving the governance and oversight of remaining SOEs so that they can function effectively as profit-making businesses. As noted earlier, the SOE sector has shrunk considerably in size, although it remains large compared to most other economies,

including most developing economies. Chinese SOEs have entirely or largely withdrawn from labour-intensive sectors of the economy.

The corporatisation process is approaching completion, with more than 80% of all SOEs, and virtually all those controlled by the central government, incorporated under the company law by the end of 2006. Most state-owned joint-stock companies have adopted governance structures with features broadly consistent with those found elsewhere, including boards of directors and supervisors that include outside members, and special audit and other committees that have been found to be crucial to effective corporate governance in other countries.³⁶ A growing number of SOEs are issuing annual reports, and the quality of those reports has improved as a result of the adoption of new accounting standards based on international best practices.

These reforms are fostering (and indeed are essential to) the transformation of SOEs away from their earlier role as agents of the plan into competitive profit-oriented businesses. The effectiveness of the reforms should improve as experience is gained with their implementation. Even where reforms are adopted, the committees and independent directors are not always functional due to lack of experience and the difficulty of finding qualified personnel. The ultimate benefits of the reforms are clouded by the ongoing difficulty of decisively severing the traditional ties between SOEs and government agencies and officials. Nearly half of the board chairpersons of central government-controlled SOEs, and more than one-third of the chief executive officers, have civil servant status, although the portions are lower for enterprises controlled by local governments (Hu, 2007). The limited protections for minority shareholders, although they are being strengthened, also diminish the effectiveness of the governance structures in promoting the interests of all the owners (OECD, 2008a).

Theory and experience in other countries suggest that the stock market provides important market discipline for enterprises, through the market judgement on performance reflected in the company's stock price and by allowing control to be contested. This experience has encouraged Chinese authorities to make stock market listing a central element of their SOE reforms. More than 1 100 wholly or partially state-owned enterprises, including most of the largest, were listed on the domestic exchanges by mid-2008, and more are expected to list in the coming years (*Xinhua News Services*, 2008). The listing process has had a positive effect on SOE incentives, since approval to list is based on a firm's performance and progress in implementing reforms.³⁷ Evidence on whether listing has subsequently improved performance is mixed, however: listed firms have performed better than non-listed companies with comparable characteristics, but this is at least partly because better-performing companies were given priority in listing. Moreover, SOEs' performances often deteriorated following their listing in the late 1990s³⁸ (Green, 2003).

The ability of the stock markets to discipline performance has been blunted by a number of factors: a tendency for prices to poorly reflect economic fundamentals, due in part to the dominance of trading by individual shareholders; the overwhelming control of the major state shareholders and limited power of minority investors; and, most important, the prohibition until recently on trading on the exchanges of the nearly-two thirds of shares directly owned by the state or state entities. Recent reforms and other developments are beginning to remedy these effects. The China Securities Regulatory Commission (CSRC) has strengthened enforcement of prohibitions on insider trading and

other abuses while encouraging companies to improve the transparency of their operations. Institutional investors, who in other countries play a key role in ensuring that market prices accurately reflect their fundamentals, are becoming an increasingly important presence in the markets (OECD, 2008a). Most important, under the reform introduced in 2005, all previously non-tradable shares have been converted and will become fully marketable by the end of 2009.³⁹ The reform should help greatly to improve market efficiency and provides the foundation for development of a more active market for corporate control.

The establishment in 2003 of the State Asset Supervision and Administration Commission (SASAC) marks an important step toward improving the state's exercise of its ownership in the SOEs. The central government SASAC now supervises 156 large SOEs, most of which are holding companies with many state controlled subsidiaries, and local SASACs have been established in provinces and major cities to oversee the holdings of their governments. The SASACs' basic responsibility is to monitor and manage state investments in SOEs so as to maximise their overall value, but without interfering directly in management or day-to-day operations. The commission exercises the state's voting rights in the boards of the SOEs they control, and typically designate the chairperson of the board of directors and the chief executive officer. The central government SASAC also formulates rules and standards for SOEs and oversees the local SASACs to ensure that they comply with central government mandates. Through these means, SASAC has become an important positive force for improving and implementing reforms to improve SOEs performances.

SASAC's mandate differs from that prescribed in the OECD Code for Governance of State Owned Enterprises (2005) in that it does not focus exclusively on exercising the state's ownership function but also has substantial regulatory responsibilities, including responsibility for restructuring in some of the industries where SOEs are now dominant. These regulatory functions may be necessary as a transition step to facilitate the extensive further restructuring of the SOE sector that is needed. However, experience in other countries suggests that mixing regulatory and ownership functions tends to degrade the quality of both. The SASACs face daunting challenges in their ownership role given the still very large number of SOEs and their wide scope of activities. The central government SASAC task is particularly great since it has only indirect control over the thousands of companies held by its SOEs which have increasingly complex and often opaque structures (Naughton, 2008).

The beginnings of regulatory reform of monopoly sectors

Significant progress has been made over the past decade in regulatory reform of energy, utility, and network industries previously dominated by state monopolies. In 1999, two new state telecommunications companies were split out from China Unicom, the state monopoly established in 1994, to provide satellite and mobile communications services respectively, while China Unicom retained its monopoly of fixed-line services. This was followed in 2002 by division of China Unicom into two competing oligopolies, and then a similar split of the mobile phone company. The state monopoly over electricity came to an end in 2002 with the creation of five regional power generation companies and two transmission companies to operate as regulated monopolies, subject to the State Energy Regulatory Commission (SERC). In 2005, a Renewable Energy Law was enacted to encourage development of alternatives to hydrocarbons. However, as indicated in Chapter 5, the legal

and regulatory framework in several these sectors needs to be completed and further strengthened and pricing needs to be reformed.

Segments of the electricity, telecommunications, and water sectors have been opened to private participation – including, subject to some ownership restrictions, foreign providers. Authorities have encouraged foreign investment in the electric power sector since the mid-1980s, although foreign private investors did not begin to participate until the mid-1990s (IEA, 2006). Domestic as well as foreign companies are allowed to offer services in segments of the telecommunications and water sectors. The authorities plan to open the power generation sector to competing providers at some future point.

Designing the rules and vehicles that maximise incentives for performance and effectively share the risks between private and public participants is a major regulatory challenge. Chapter 7 describes the various types of private-public partnerships that have been evolving in the water sector and notes that the framework for these partnerships is now fairly well developed. Nearly 15% of urban water is provided through such arrangements, 40% of which involve a foreign partner. In recent years, most partnerships have been in the form of build-operate-transfer arrangements in which private participants bear much of the risk but also reap the bulk of the profits. The BOT arrangement is also becoming the preferred vehicle for foreign investment in the electricity sector.

The benefits of regulatory reforms together with infrastructure investments have been most impressive in the telecommunications sector, whose development has been given high priority because of its importance to China's industrial development. China's telephone system has become the largest and fastest growing in the world, with 51 telephones per 100 persons compared to less than 3 in 1990; moreover, the country is close to surpassing the United States in terms of the number of Internet users (Li, 2008). In other sectors, the benefits are emerging more slowly. Although China's energy efficiency rose during the 1990s, it has started to fall back during the current expansion. Alleviating the boom-bust cycle in the electricity cycle that has afflicted China's economy for several decades is a major goal of reforms in that sector but did not prevent the emergence of severe shortages during 2002-06 (IEA, 2006).

Improved regulatory capacity, continuing problematic relations among government levels

Organisational and administrative reforms taken over the past decade have considerably improved the capacity of the central government to effectively regulate the market economy. The 2003 government reorganisation, the fifth major administrative reform of the reform era⁴⁰ and the most extensive, marks a formal and decisive embrace of market-based regulation in place of economic planning. The reform reallocated regulatory responsibilities along functional lines. The newly created Ministry of Commerce assumed the functions previously exercised by the State Economic and Trade Commission and the Ministry for Foreign Trade and Economic Co-operation, while the former State Development Planning Commission was reorganised into the National Development Reform Commission, with enhanced responsibilities for economic reforms. The reorganisation formally incorporates the integration of domestic and foreign economic policies into the government structure. The reform also created two new agencies, the CBRC and SASAC, which are playing major roles in the reform process.

Reforms have also improved the efficiency and quality of the central government workforce. Central government staffing has been cut by nearly 50% since the 1998 administrative reform. This together with a series of pay increases has improved the overall capabilities of the remaining staff and helped (although only partly) to retain staff in the face of rapidly rising salaries and opportunities in the business sector.

Budget reforms – notably the introduction of a Single Treasury Account and institution of formal department budgets in place of the traditional system, under which many departments received earmarked funding sources whose use they largely controlled – have improved the central government’s capacity to plan and control revenues and expenditures. Extra-budget accounts, which in 2001 accounted for more than one-quarter of total government on-budget revenue and more than 4% of GDP, and which were subject to less stringent oversight and control, have been progressively moved onto the formal budget (OECD, 2008a).

Improvement in the organisation and capabilities of sub-national governments has been much less noticeable than that at the central level, however. This is only partly because organisational reforms initiated by the central government take time to be implemented at lower levels. The formal relations among government levels have not been fundamentally reformed since the 1994 tax reform, which mainly focused on reallocation of tax revenues. With a few important exceptions, the basic features of these relations, notably the jurisdiction of local governments over local departments of government agencies, have not changed appreciably since the beginning of reforms. Problems of lack of clarity, overlap, and inconsistent priorities in the allocation of responsibilities among and between central and sub-national government organs have become greater as the economy has developed and economic policies have become more complex. Large gaps between local governments’ expenditure responsibilities and the fiscal resources they have to meet them have become an important impediment to national policy objectives in a number of areas. As discussed further in the next section, the need for reform of fiscal relations among government levels has become increasingly acute.

Strengthening of the financial regulatory regime and broader financial reforms

The development of China’s financial system illustrates how improvement in the regulatory apparatus can provide a major impetus to broader reforms. China’s financial regulation through most of the 1990s was handicapped by fragmentation among a number of financial and non-financial bodies with overlapping and sometimes conflicting mandates. This was particularly true of the capital markets; there the China Securities Regulatory Commissions (CSRC), the governing authorities of the Shanghai and Shenzhen stock exchanges, and their local governments shared responsibility for stock market regulation and were involved with the State Development Planning Commission, the PBC, and Ministry of Finance in various aspects of bond market regulation. Regulation was primarily command and control, and subject in some areas to industrial policy and other non-prudential considerations.

Reforms drawing heavily on international experiences and benefiting from the participation of several international financial bodies over the past decade have resulted in a much-improved financial regulatory system with improved capabilities and tools. The 1997 Asian financial crisis, which underscored the major risks posed to economic stability by distortions in the financial system, has provided a further important impetus and lessons for China’s financial reforms. All depository institutions along with trust and

investment companies are now subject to the CBRC. The CSRC is primarily responsible for regulating the stock markets, the instruments traded, and their participants, including securities companies, while the China Insurance Regulatory Commission (CIRC) oversees the insurance sector. Some vestiges of older system remain, notably in the bond market where trading is divided between the interbank market and the stock exchanges and where the NDRC still has authority over bond issuance by non-listed companies. But overall, the lines of responsibility are significantly clearer and more consistent than they were ten years ago.

Regulatory strategies and tools have become more sophisticated and, probably more than in any other sector, aligned with international standards and best practices. Regulation has moved away from detailed control over the investments, products and operations of financial institutions to focus on establishing and enforcing basic prudential standards while ensuring that the institutions have the incentives, governance, and internal systems to sustain those standards. In the insurance sector, for example, traditional regulation through model contracts and prescribed pricing has largely been replaced by pre-notification. Authorities have made extensive use of conditionality in promoting reforms, notably by making progress on implementation by financial institutions a requirement for approval to enter new lines of business.

The improvement in financial regulation is largely responsible for the acceleration and broadening of financial reforms over the past five years. Improved regulatory capabilities were essential to the recapitalisation and restructuring of the securities industry during 2003-07 and have been instrumental to the emergence of a more comprehensive strategy to reconstruct the rural credit system (OECD 2008a). Financial institutions' standards and practices are increasingly coming into line with international standards. All of the nationwide banks and nearly all city commercial banks have adopted loan classification systems and capital adequacy rules broadly in line with BIS norms, and the standards are being extended to rural credit institutions.

Improved regulatory capacity has been a precondition for the gradual broadening of financial institution portfolio choices, products, and lines of business that is essential to the development of the financial system and critical to containing systemic risk. The success of financial regulators in promoting the strengthening of financial institutions' prudential capabilities, and their ability to enforce those norms and contain abuses, will be critical to the extent and timing of further capital account liberalisation.

Monetary policy instruments

Since the late 1990s, China's monetary policy authorities have been developing market-based control instruments to influence nominal spending and GDP through changes in the quantity of money and interest rates rather than through administrative controls on lending. The foundation for this development was laid in the late 1990s with the termination of the credit plan and the reorganisation of the PBC into regional branches, (in part) to tighten control over local branches that had undermined monetary control in the past. These steps were followed by gradual interest rate liberalisation leading to the freeing of interest rates on the interbank market; the progressive widening of the permissible band for bank lending rates; and, in 2004, complete abolition of the ceiling on bank lending rates.

The interbank market, a critical element in the monetary policy transmission mechanism, has grown impressively in both size and breadth. Nearly all financial institutions, including foreign banks, now have direct access to the market. Repurchase agreements and other basic instruments are well developed and derivatives to improve risk management are beginning to be introduced. The growth of the money market has facilitated the development of central bank open market operations, which began in the late 1990s, as the key operating instrument for controlling commercial bank reserves. The PBC remains formally subject to the State Council, which must approve changes in the central bank lending rate; since 2004 however it has been able to apply a surcharge without approval, and with considerable effective autonomy in determining that rate (Green, 2005; Geiger, 2008). The monetary policy framework has become increasingly sophisticated, with targets for money growth and other attributes similar to those found in more advanced economies. Monetary policy operations are becoming more transparent: the PBC now publishes a quarterly detailed account of its policies, *Monetary Policy Report*.

The transmission of monetary policy was weakened for much of the past decade both by the financial problems of banks, which blunted the impact of changes in central bank operating instruments on money market and bank interest rates, and by the incomplete commercialisation of the business sector, which limited the sensitivity of spending to interest rates. However, these impediments have become less important as bank financial conditions have improved, the private sector has developed, and SOEs have become increasingly market oriented (Green, 2005).

Overall, the framework and instruments now exist for conducting effective monetary policy in a manner similar to that followed in more advanced economies. However, these instruments do not seem to have been fully employed during the current expansion. In principle, central banks need to adjust their instruments to restrain credit growth and induce a rise in bank loan and other interest rates in real terms when the economy is starting to overheat. Although official interest rates have been changed several times since 2003, the overall rise has been modest and has failed to keep pace with rising inflation.

Monetary policy during this period has increasingly had to cope with the massive inflows of funds into bank reserves arising from the large and growing balance-of-payments surplus. Despite extensive capital controls, the BOP surplus has been driven by largely unrecorded capital inflows, probably motivated in part by expectations that the RMB will have to be revalued. Without a revaluation, the present exchange rate regime does not allow the RMB to rise enough to contain, much less reduce, the surplus. The monetary authorities have been remarkably successful in controlling bank reserves through sales of central bank bills and increases in reserve requirements, but there are signs the sterilisation is becoming more difficult⁴¹ (Green, 2005). The reluctance to use interest rates more actively may reflect concern that they would add further to the inflows. Thus the limited flexibility of the exchange rate regime seems to at least be complicating the task of monetary policy (Goodfriend and Prasad, 2007).

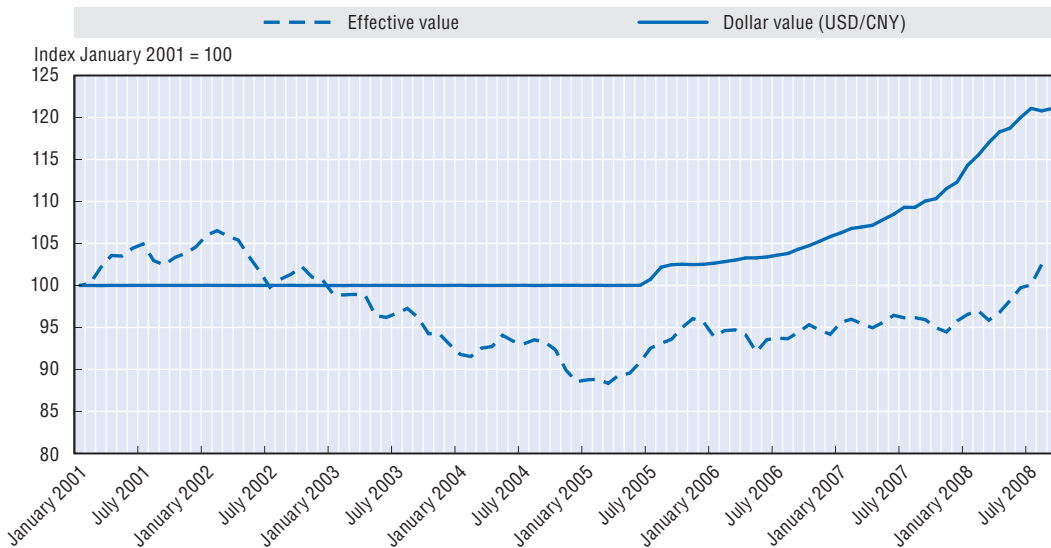
The need for a more flexible exchange rate regime

The July 2005 exchange rate reform established the preconditions for greater currency flexibility, but it has been overtaken by developments in world markets. Under the reform the RMB was immediately revalued by 2% against the US dollar, and the previous *de facto* peg against the dollar replaced with a basket of major currencies whose exact composition

has not been disclosed.⁴² The reform was intended in part to provide for a gradual adjustment in the currency's value, to better maintain external balance in the current account and overall balance of payments.

The RMB has since (by September 2008) appreciated by about 21% against the dollar; the rate of appreciation has picked up somewhat since early 2007, and the daily permitted range for fluctuations against the dollar has been widened.⁴³ However, as a result of the steady decline in the dollar's value against the European euro and Japanese yen, the effective value of the RMB has risen by much less – 10.7% since July 2005. Moreover, its level is now the same as in 2003. The appreciation has not prevented the current account surplus from rising to over 11% of GDP in 2007, or a continued increase in the balance-of-payments surplus. While, as noted earlier, the authorities have been able to maintain control of bank reserves and bank lending, there are increasing indications that the large capital inflows have contributed to speculative pressures in the property and stock markets, and may be constraining the use of interest rates to prevent economic overheating.

Figure 1.6. RMB dollar and effective exchange rate



Source: Bank for International Settlements.

This situation underscores the need to increase the effective flexibility in the exchange rate regime as soon as possible. At the very least, this will entail establishment of the currency basket as the actual benchmark for official foreign exchange policy, as opposed to the crawling peg against the dollar that now effectively prevails. Limits on short-term fluctuations against individual currencies, notably the dollar, will need to be increased further in order to allow meaningful short-term fluctuations in the RMB's effective value against the basket. This will require significant technical adjustments in the authorities' exchange market operations. But, given its considerable development in recent years, the foreign exchange market should be capable of accommodating such greater flexibility.

Further capital account liberalisation would help in developing a more efficient exchange market and thereby facilitate the transition toward a freely floating exchange

rate similar to that governing other major currencies (OECD, 2008a). Particularly since the 1997 Asian financial crisis, China's authorities have been understandably cautious in liberalising capital account transactions, to ensure that those transactions do not get ahead of the capabilities of financial institutions and markets to manage their risks. The adoption in 2001 of the Qualified Foreign Institutional Investor programme (QFII) followed in 2006 by the Qualified Domestic Institutional Investment (QDII) programme marks significant steps toward, respectively, opening the Chinese capital markets to foreign participation and allowing Chinese institutional investors to diversify their portfolios to include foreign assets.⁴⁴ Nevertheless, China's capital account remains relatively restricted, even compared to those of other emerging economies such as India whose financial system is also developing.

The current world financial crisis has further underscored the need in China for continuation of a carefully phased approach to capital account liberalisation. Nevertheless, a number of considerations suggest that the liberalisation could be broadened and perhaps somewhat accelerated without undue risk, and with significant benefit to financial system development as well as achievement of a flexible exchange rate. First, the macroeconomic conditions that international experience suggests are essential preconditions for liberalisation – notably a sustainable fiscal deficit, low inflation, moderate government and external debt, and ample (indeed more than adequate) foreign exchange reserves – have been in place for some time. Financial institutions are now more able to evaluate and manage risks as a result of financial reforms, and financial regulators are more capable of overseeing those risks. Moreover, as has happened in other countries, capital controls are inevitably subject to evasion and tend to become increasingly porous over time. Faster liberalisation would reduce incentives for evasion, helping to reduce misreporting and potentially improving the ability of the authorities to enforce remaining limits and to monitor the exposure of the domestic economy to foreign exchange and other external risks.⁴⁵

Regulatory reform: The remaining challenges

While further reforms will be needed in all of the areas discussed in the last section, their emphasis is likely to be somewhat different from those of past decades. With many of the fundamental steps having been taken, future reforms are likely to focus on completing the established frameworks and on strengthening implementation; the emphasis is likely to be on judicial, competition, and other policies applying to the economy as a whole rather than to individual sectors. The ultimate outcomes of reforms in some areas will partly depend on how two political questions are resolved: the role of the Party in state businesses and institutions; and the scope and modalities for citizen participation in the policy process.

The quality of regulation will be increasingly central to this next stage of economic reform. Reform is becoming an increasingly dynamic process requiring not only new measures, but also modification and in some cases discarding of existing policies as the economy develops. The success of this process depends on embedding several fundamental principles in the regulatory process. As discussed in Chapter 2, the regulatory process needs to be transparent and open to consultation with those affected if regulations are to be effectively implemented and unanticipated negative consequences minimised. Effective tools need to be incorporated in formulating regulations to ensure that they are not excessively burdensome or unnecessarily discriminatory. Such tools are particularly

important in those areas where specific regulatory objectives need to be balanced against other policy considerations. Finally, an effective regulatory process requires coherent co-ordination among concerned government agencies and especially government levels to achieve a proper division of labour, good communication among regulatory actors, and accountability.

The remainder of this section discusses key remaining challenges for China's economic reforms, highlighting their implications for the regulatory process in three broad areas:

- Reforms to clarify the scope of state involvement in the economy and the respective roles of the state and private domestic and foreign businesses in the economy.
- Reforms to further strengthen regulatory institutions and tools.
- Policies to extend the scope of reforms to lower government levels and other segments where reform is less advanced.

Further reduction in the SOE sector

Although much smaller than a decade ago, China's SOE sector is still greater in scope than seems warranted on the basis of strict economic criteria. China is virtually unique in its state dominance of all major segments of the financial sector. Chinese SOEs still dominate in the automobile, steel, and other metals industries; state enterprises have largely been withdrawn from these industries in most other countries on the grounds that state ownership is unnecessary and less efficient than private ownership. The continued role of Chinese SOEs in these sectors at least partly reflects policies pursued since the 1980s to emulate earlier attempts by Japan and Korea to develop "national champions". However, China's efforts to develop such champions have had at best meagre results, in part because the international integration of product and financial markets and changes in the organisation of global business have greatly reduced the potential payoffs to such interventions (Nolan, 2002). Moreover, any need for government intervention that might have existed earlier is declining as reforms in, *inter alia*, corporate governance and the financial system to improve business sector functioning progress.

Withdrawal of SOEs over time from competitive sectors could significantly improve performance in the sectors themselves, and thereby benefit the overall economy. This conclusion is supported by evidence that private enterprises have higher productivity and profitability than SOEs, and that privatisation of SOEs tends to improve their performance (Dougherty and Herd, 2005; OECD, 2005b). Limiting the scope of SOEs to national security or other sectors where their presence is genuinely essential to national objectives would reduce the risk that SOEs will again become a major drain on public finances, as they so often have in other economies.

The need to at least reduce the extent of state ownership is particularly compelling in the financial sector, where the contrast between nearly complete state ownership and the prominence of private business in the real sector is striking and growing. Moreover, banking, insurance and the other major financial segments are dominated by very large state-owned institutions with traditionally close links to the central government.⁴⁶ In the banking sector, the market share of the SOCBs has been falling only very gradually. As the SOCBs have been the least efficient segment of the banking sector, their dominance lowers overall productivity. Reforms have significantly improved banks' commercial incentives and ability to assess credit risk, and are slowly breaking down the traditional bias on the

part of the large banks toward lending to SOEs.⁴⁷ However, whether the system in its current structure can become as effective as counterparts in other countries, or adequately serve the needs of the growing private sector, is at least questionable. Again, international experience is not encouraging. Much evidence suggests that state-owned banks tend to be less efficient in their operations, less effective in allocating credit, and more prone to incur financial difficulties, than privately controlled banks (Hope and Hu, 2005; LaPorta, López-de-Silanes and Shleifer, 2002; Arun and Taylor, 2002).

Government encouragement and the development of the stock market and other reforms have led to significant diversification in ownership of SOEs and greater prominence of private minority investors in sectors still dominated by the state, including the financial sector. On the other hand, minority investors tend to have little influence on enterprise decisions in China, although recent reforms have been undertaken to increase their voice. Private interests have been able to acquire controlling interests in a growing number of listed state-owned companies, and the reform of non-traded shares should eventually foster the development of a more active market for corporate control. Nevertheless, state dominance, especially in the financial sector, is unlikely to decline more than gradually without an explicit government commitment to withdrawal and development of specific measures and timetables for achieving it.

Reduction in the scope of the SOE sector would also help to improve the exercise of the government's remaining ownership stakes and to contain interference by government agencies and government and Party officials in business decisions. Effective oversight by SASAC would be easier to achieve if it were responsible for a smaller and more narrowly focused group of SOEs. Such reduction might also facilitate concentration of SASAC's mandate on ownership exercise and the eventual transfer of its regulatory responsibilities to other agencies.

Greater foreign access to service sectors

Although China has opened its services sectors considerably under its WTO commitments, further liberalisation of access for foreign investors and businesses could bring substantial benefits. Increased access by foreigners can help in reducing SOEs dominance, improve competition, facilitate transfers of technology and know-how, and improve the variety and quality of services offered.⁴⁸ Foreign participation can be particularly fruitful in sectors whose development has lagged behind the needs of the economy.⁴⁹ Foreign investment is greatly needed and in some cases has long been actively sought to help finance the massive investments required in energy, water, and other infrastructure-intensive sectors.

Many countries, including China, have sought to protect their service sectors from foreign access because of concerns that foreign companies, with often greater capabilities, will harm domestic counterparts and prevent them from developing their potential competitiveness (the “infant industry” argument). Experience suggests that these concerns, if not entirely misplaced, are at least exaggerated. Domestic firms typically have considerable advantages over foreign firms in terms of their knowledge of the market and customers and familiarity with the local business culture. While foreign firms may initially make substantial inroads in high-profit segments requiring high technology or other expertise, their advantage is likely to erode as domestic firms develop their capabilities. China's experience in the banking sector is consistent with these observations. It was widely feared before WTO accession that foreign banks would make large inroads into the

domestic market and increase pressures on the already fragile domestic banks. In practice, foreign banks' market share has increased very little since 2001 and is still quite small, while domestic banks are in much better condition than they were then and have also been expanding and improving their products.

Foreign service providers have faced three types of barriers to entry into the domestic markets: restrictions on their ownership form and ceilings on the maximum share they may own in a domestic firm; restrictions on their geographic scope and lines of business; and other requirements, such as minimum capital requirements, not imposed on domestic competitors or imposed to a lesser degree. These restrictions have been substantially relaxed since WTO entry. Foreign banks and non-life insurance companies now enjoy close to national treatment, although ceilings on foreign investment in domestic banks and insurers remain. Foreign securities companies and mutual fund companies are still prohibited from establishing wholly owned subsidiaries and their maximum stake in a joint-venture or domestic company is subject to ceilings. Foreign participants in the telecommunications sectors and electricity sector face similar ownership restrictions and are confined to value-added services and power generation, respectively. These restrictions limit not only the market share of foreign providers but also the breadth and sophistication of the services they provide, since foreign companies are often reluctant to transfer technology or expertise in ventures where their control is limited.

As noted in Chapters 3, 5, and 7, foreign investors also face uncertainties and risks from the lack of transparency in laws and regulations, discriminatory treatment by local governments, uncertainties about enforcement, and weak intellectual property protection that are usually greater than those faced by domestic firms. Allowed rates of return in regulated monopoly sectors are often insufficient to compensate for the higher risks. Reduction in these obstacles is also important to raising the quality as well as quantity of foreign participation, and will require extensive further reforms to improve regulatory capacities.

Pricing reform – essential in utilities industries and urgently needed in energy

Establishment of effective pricing mechanisms in sectors where regulation is required presents formidable challenges. The pricing system needs to afford a return on investment sufficient to guarantee expansion of capacity in line with demand. Ensuring that prices to end-users reflect the full social costs of provision, including environmental costs, is essential to sustainable development objectives. Pricing mechanisms also need to provide sufficient encouragement for improvements in efficiency and innovation. Distortions in pricing can impose major costs through inefficient resource allocation and by stifling industry development. The importance of energy, water, and other utilities in household budgets further increases the difficulty of establishing effective pricing, since attempts to use price regulation rather than other means to ensure affordability and equity can easily impair achievement of the other objectives.

China has been moving towards more efficient pricing in its utilities sectors, but the process is uneven and incomplete. Most urban residents now pay for water via consumption charges, but these are typically below the level needed for full cost recovery. Wastewater charges, when they are imposed, tend to be applied to all users regardless of their use and many cities do not impose such charges at all. Overly low water prices in agriculture in relation to costs has encouraged overuse and pollution, and contributed to the shortage of water in some urban areas. Thus Chapter 7 argues that there is a need to

review the pricing system so as to better reflect the scarcity value of water resources, while preserving access of the poor to essential services. Further progress is required towards full cost recovery in order to enhance market base integration and encourage sustainable water use.

Price reform is most urgently needed in the energy sector, where the failure of regulated prices to keep pace with changes in costs has led to serious recurring problems. Defects in pricing have been an important contributor to the periodic shortages in energy, most recently during 2003-06, due to inadequate investment to keep up with rising demand. The establishment in 2002 of a two-tier pricing system under which newer generation plants receive tariffs based on their marginal costs is expected to better ensure an adequate return on new investment. Average electricity prices for industry in China are relatively high compared to those in OECD countries and a number other developing countries (Rosen and Hauser, 2007). However, retail prices for electricity as well as gasoline and home energy sources are generally below those in OECD countries and too low to promote adequate conservation and efficient use⁵⁰ (Rosen and Hauser, 2007; IEA, 2006).

The administration of retail prices for electricity, gasoline, and other energy sources has become increasingly difficult with the rise in world energy prices, and has led to gyrations in policies. The authorities froze retail energy prices at the beginning of 2007, in part in an attempt to dampen rising inflation in retail and consumer prices while allowing crude oil and coal prices to vary with the market. This led to increasing subsidies to compensate oil refiners for losses and a reversal in policy in mid-2008, when retail energy prices were increased, the price of thermal coal was frozen, and exports were forbidden. Such policy fluctuations do not help to create the market predictability needed to ensure adequate investment in capacity and in conservation.

The authorities are committed to eventual liberalisation of energy prices but have not specified a timetable. The basic need in electricity is to establish pricing that reflects costs in all components, from extraction and refining and distribution to end-users (IEA, 2006). Price reforms have been tied to the introduction of competition in power generation but earlier steps are likely needed to achieve more flexible pricing and so avoid the problems that have been occurring.⁵¹ Greater flexibility in the exchange rate regime, which would allow the RMB to appreciate more rapidly, could help make liberalisation of retail energy prices more palatable by dampening costs.

More effective pricing, as well as maximisation of benefits from private participation and support of environmental goals, will all require further changes in the legal framework and strengthening of the regulatory institutions and processes. A comprehensive telecommunications law is increasingly needed to provide the foundation for the industry's further development (Li, 2008). Chapter 7 highlights the need to strengthen the regulatory framework for water provision and sanitation, clarifying responsibilities and improving consistency among the numerous national and local agencies. Separation of regulation from water delivery needs to be completed, with local governments concentrating on the former while divesting their ownership stakes in providers. Water quality (along with other environmental concerns) needs to be better integrated into broader economic policies, for example by developing integrated river basin managements in which local responsibilities are clearly defined.

The legal and regulatory framework particularly needs strengthening in the electricity sector. The law governing electricity needs to be updated to strengthen the role of the SERC

as the primary regulator and to explicitly incorporate environmental considerations into its mandate (IEA, 2006). The responsibility of the NDRC for electricity pricing, given its broad responsibilities for economic reforms and close relation to government authorities, can encourage conflicts with other objectives and may politicise the process. Conflicts are further encouraged by the present requirement for the national NDRC to negotiate regional prices with local authorities. At the very least, regulatory authority for electricity prices needs to be concentrated in the SERC with a clear mandate to establish cost-reflective pricing as the primary priority. The role of the NDRC needs to be limited to setting the basic rules and criteria for pricing within this mandate.

Equally important, regulatory processes and tools need to be improved. In electricity as well as other sectors, the methodology and rationale for pricing needs to be made transparent to ensure that the cost principle is objectively and fairly observed and not diluted by other considerations. Legal but also institutional safeguards need to be developed to prevent regulated firms from interfering with (“capturing”) the sector regulator.

The tools of regulatory impact analysis and competition policy are especially needed in former monopoly sectors, given the interdependence of monopoly and competitive characteristics and the need to balance competing policy objectives. For example, regulatory impact analysis tools can be very useful in designing cost-effective regulations to contain pollution and promote other environmental objectives. Competition policy tools are likely to be essential in establishing competition in the electricity sector (see Box 1.6) as well as in designing pricing and access rules in telecommunications. Both sets of tools could be useful in refining public-private partnerships in the water and other sectors, to maximise incentives for efficient operation and equitably distribute risks among the partners.

Strengthening the rule of law – more than simply enforcement

Ultimately, the success of reforms and an improved regulatory process will depend on the extent to which the rule of law is established on a firmer and broader basis. Administrative directives and regulations can only go so far in ensuring that government officials implement laws and regulations in a manner consistent with their intent. Containment of corruption and its corrosive effects on the government’s credibility in managing the economy in the public interest ultimately depends on strengthening confidence that laws will be enforced and lawbreakers effectively sanctioned. Establishment of the rule of law in fact rests not only on more effective enforcement but also, and as importantly, on ensuring that laws and regulations are clear and well understood, and on reducing incentives and opportunities to violate them.

Chapter 2 discusses two features of the lawmaking process in China that complicate the establishment of the rule of law. First, the highest-level laws, notably those enacted by the National People’s Congress, typically focus on broader principles and goals but are often unclear about concrete issues, leaving ministries and other lower legislative organs to elaborate the specifics through regulations and decrees. This practice has the advantage of flexibility in that it allows laws to be effectively adapted to changing circumstances – but given the absence of mechanisms to limit lower-level bodies’ discretion, it can undermine the original intent of a law and lead to inconsistent application. Second, China is governed by a plethora of laws, regulations and decrees issued not only by central and local governments and their agencies but also by lower-level People’s Congress’ and Party organs

whose relative status is often very unclear. The result is that it can be difficult to determine what law or regulation should prevail in specific cases.

Reforms to strengthen the judicial system are clearly essential to strengthening the rule of law. The unpredictability, discrimination and delays in judicial processes have been among the biggest concerns of foreign investors in China and are nearly as great a problem for domestic businesses and individuals. Equally important, the judicial system will be critically needed in coming years to provide interpretation of the competition, property rights and other laws that are the foundation for further economic development. For example, Chapter 3 highlights several aspects of the AML that likely will have to be tested and refined in the courts. Several new laws, including the Amended Securities law and the AML, provide greater latitude for individuals and businesses to institute civil proceedings against proscribed practices, including those by government agencies. These new laws are at least partly responsible for a dramatic increase in the number of litigation cases brought before the courts, from an average of 7 million per year over 2000-05 to 10 million during the first half of 2007 (Wan, 2007).

The judicial systems' ability to meet these challenges has been seriously impaired both by weaknesses in its own capacities and by external constraints on its authority. Judicial officials have been making efforts to reduce the first set of problems, notably through training, better selection, and other measures to raise the educational standards and professionalism of judges. Measures have also been taken to improve the transparency of judicial processes and decisions.

The greater challenge is to establish a genuinely independent judiciary free of undue interference from administrative or other outside political officials. This role is manifest in the responsibility local governments still have for funding local courts and appointing and certifying their judges. Judges can be administratively punished for incorrect decisions rather than simply reversed on appeal; and partly for this reason, lower-level judges tend to consult higher levels before making difficult decisions (OECD, 2005b). Judicial deliberations are subject not only to government but Party interventions – notably in complex cases involving a number of judicial divisions, or where no applicable law exists or existing laws run counter to revised Party policies (Hung, 2005). Thus the portion of civil and commercial cases involving government agencies is very low by international standards – in the low single digits (OECD, 2005b; Hung, 2005). Indeed, the judiciary's legal authority to overrule government policies is not unequivocally established in the law.⁵² Further legal and other reforms to define the judiciary's jurisdiction *vis-à-vis* the government and to prevent interference from government and Party officials are essential to facilitate rather than hinder the implementation of regulatory and other reforms.

Success in checking administrative abuses and corruption depends as much on limiting opportunities and incentives for such behaviour as it does on enforcement. Excessively large numbers of required applications and procedures facilitate such practices. The opportunities are magnified when regulations are inconsistent or unclear and where the application of regulations lacks transparency, since they increase the discretion of officials while making it difficult to determine if their decisions are justified. Conflicting regulations or mandates also encourage violations by forcing officials to choose between acting within the law but failing to meet superiors' requirements, or going outside the law and succeeding. Thus reforms to improve the consistency and efficiency of regulations will be key to achieving greater honesty and rigor in their application.

Competition policy and other tools to strengthen the regulatory process

The profound transformation in regulation that is now occurring in China creates major challenges to ensuring that regulations in different areas are consistent, efficient in accomplishing their specific goals, mutually reinforcing in achieving policy priorities, and adaptable as conditions change. This is true in all areas but particularly in sectors such as natural monopolies, where a number of considerations – such as competition, efficiency, national security and equity – need to be balanced and where regulatory reform is in at early stage. In a market economy, consistency and mutual reinforcement in regulatory policies cannot be achieved by administrative rules and fiat, as was the case in the command economy. Instead, well-defined tools and criteria are needed to establish high-quality regulatory processes that can achieve these goals. The process needs to be objective, supported by sound analytical tools and good data and information, and actively managed to ensure that its quality is sustained.

As discussed in Chapter 2, establishment of such processes involves extensive institutional, legal and other reforms that are likely to take considerable time and whose exact form depends on a country's history, governance and social and economic circumstances. Tools not only need to be developed and adapted to country circumstances, but also embedded in the mandates and procedures of individual agencies. Reforms to the administrative registration and technical standards systems described in Chapter 4 as well as measures to improve the investment climate mandated by China's WTO entry mark a beginning of the formal incorporation of efficiency, competition, and other fundamental goals in the regulatory process. But the overall effort is at an early stage.

As in other reform areas, the effort to improve regulatory quality in China could benefit from experiences from and tools used in other countries. Regulatory impact analysis, which can be viewed as an extension and generalisation of traditional cost-benefit analysis, has become the primary tool of regulatory reform in the OECD area, and its use has expanded greatly in recent years (Jacobs, 2006). The purpose of regulatory impact analysis is to assess the benefits, costs and other effects of government regulations. It provides an empirical basis for determining whether government intervention is appropriate in a given area and, if so, the most effective way to achieve the goals in question. As such, it helps to improve not only regulation in particular areas but also co-ordination of regulation across the government, as well as transparency and implementation. Regulatory impact analysis is not a single methodology but encompasses a range of principles and tools that in OECD countries have been adapted and applied to a variety of areas depending on individual country priorities. Regulatory impact analysis is concerned not only with the analysis of regulatory policies but also with their effective communication to policy makers. Although the application of RIA varies widely among OECD members, a set of "best practices" has emerged, emphasising the need to effectively allocate responsibilities for RIA, to develop means to collect necessary data, to target RIA analyses to areas where they will be most effective, and to inform the public and involve them in the RIA process (see Chapter 2). Development of objective indicators to measure regulatory impacts and guide policy decisions has become an increasing emphasis.

The chapters on market opening and on competition highlight the potential benefits of using competition policy to improve regulatory quality. Competition policy, which is also increasingly widely used in OECD countries, provides a complementary set of principles and tools that can be embedded in the broader RIA process. The basic principle of

**Box 1.6. The utility of competition policy tools:
Competition in electricity generation**

China's 2002 electricity law mandates the eventual introduction of competition in electric power generation in six regional markets, in each of which any single provider can have no greater than a 20% share. However, Chapter 6 notes that fragmentation in the transmission grid means that the effective market in a given area will often be smaller than the region. Thus the 20% overall limit may be insufficient to prevent dominance by a single provider in particular markets. Moreover, the low price elasticity of demand and (when near capacity) supply of electricity enhances the gains from collusion among providers and may lead to considerable fluctuation in market-determined prices.

Competition policy tools will be needed to evaluate conditions in individual markets to determine if genuine competition exists and to detect anti-competitive practices. Such tools may also be needed to establish rules for market pricing that preserve incentives for investment and efficient operation while limiting overly disruptive swings in prices.

competition policy is that regulation should seek to ensure competition to the maximum extent consistent with other social goals (OECD, 2002, Chapter 12). The utility of competition policy in the OECD area has been enhanced by the development of a set of specific tools for measuring competition in individual sectors (OECD, 2007a). These assess the impact of alternative measures on competition as a means of identifying unnecessarily restrictive regulations, and developing alternatives that achieve the same goal with less restriction. The principles have been applied to a wide range of areas, including reforms to health, electricity, water, the environment, and foreign trade and investment. Competition policy addresses not only issues such as barriers to entry, but also the competitive implications and costs of other regulations applying, for example, to advertising, safety and standards.

Neither competition policy nor RIA is intended to impose a rigid or mechanical framework for policy decisions. Rather, their role is to provide empirical guides to support decision making through the political process, expert consultation, social consensus and other traditional means (OECD, 2002, Chapter 11). RIA and competition policy vary widely among OECD countries, in the areas where they are applied (and not applied), the priorities they must balance, and the methods used. The institutions and arrangements for implementing RIA also vary widely depending on country circumstances. Specialised bodies have been established in a number of OECD countries to oversee implementation of RIA, while in others the responsibility has been given to existing budget or public management agencies or to a cabinet body.

Comprehensive reform of relations among government levels

Nearly all of the chapters in this Review cite distortions in the relations between government levels as important impediments to effective regulatory policy. Interventions by local governments in favour of local industries or workers remain a serious obstacle to effective enforcement of laws and regulations concerning anti-competitive practices, as well as to protection of intellectual property. Shortages of funds have crippled healthcare in rural areas. Enforcement of environmental mandates has been hampered by ill-defined assignment of responsibilities among central and local government agencies and conflicts among agencies with different mandates. Other OECD studies have pointed to similar

problems in other areas in China, including education, the collection of statistics, tax collection, and enforcement of labour regulations (OECD, 2006; OECD, 2005a, Chapters 5, 6, and 11).

Underlying these problems are major structural failings in relations among government levels that have become more acute with the decentralisation of economic decision making inherent in market development. Although legally a unitary state, government responsibilities are exceptionally but also unevenly distributed in China; autonomy in formulating policies rests largely with the central government while local governments bear all or most of the responsibility for carrying out expenditure and other policies but often lack sufficient resources or discretion to do so effectively. The result is not only to weaken the capacity for effective implementation of regulatory and other policies, but also to distort incentives. The imbalance between local government mandates and the available resources to meet them encourages local protectionism and resort to unsanctioned fees and charges to make up for shortages of revenue from sanctioned sources. The combination of insufficient legally sanctioned local government discretion and excessive *de facto* discretion due to weak oversight and accountability further distorts incentives. Legal and administrative reforms to strengthen vertical accountability and oversight are clearly necessary, but unless the adverse incentives created by the misalignment of responsibilities and mandates are addressed, their effectiveness is likely to be limited.

Comprehensive reform of fiscal relations among government levels is an essential requirement for remedying these problems. Responsibilities for carrying out expenditure policies need to be aligned with the fiscal resources needed to effectively implement them at all government levels.⁵³ This entails changes not only in the distribution of responsibilities and revenues between the government and provinces, but also, for the reasons given in the prior section, changes in the way responsibilities and resources are allocated among government levels within provinces. Stronger legal and regulatory provisions need to be put in place to ensure that mandates from the central government or higher government levels within provinces are accompanied by adequate resources to carry them out. The rules for allocating fiscal responsibilities and resources across government levels within provinces – which vary considerably – need to be better defined and harmonised across the country. Allowing local governments greater discretion over certain local tax rates (for example the property tax) could also help reduce revenue gaps (OECD, 2006; OECD, 2005b).

Given the great diversity in economic circumstances of China's regions, no nationally harmonised set of expenditure and tax allocation will be sufficient to adequately align responsibilities and resources for sub-national governments. Substantial transfers, both between the central government and provinces and within provinces, are likely to continue to be needed, but the current, partially formed collection of numerous *ad hoc* transfers needs to be greatly simplified and rationalised. Transfers should also be better targeted toward areas where they are needed and better designed to improve incentives of governments to effectively implement policies. For example, transfers tied to local tax increases, originally instituted to improve revenue collection, are less necessary now that the capacities of the tax authorities have been improved and could be replaced over time with other types of transfers. Greater use of general purpose grants would allow local governments better flexibility to tailor their services to local needs.

Reforms are also needed to rationalise relations among sub-national governments and improve their efficiency. Local government workforces are still excessively large compared to their responsibilities (due in part to hiring of workers laid off from SOEs) and need to be further downsized. Redefinition of county and township jurisdictions for a more optimal scale – many of these are very small – could yield significant efficiency gains (OECD, 2006).

Equally important, incentives of local officials to effectively implement policies and national mandates need to be improved. Despite some modification in recent years, the evaluation system for local officials still overly emphasises aggregate growth and infrastructure spending, and so tends to weaken incentives to improve education, health and other services. Further refinement in the system is likely to be needed to better take account of these areas now underweighted. Ultimately, however, quality in local government requires mechanisms for feedback from and accountability to local residents. Efforts to improve the transparency of local government decisions and experiments in the election of local government officials represent initial steps toward developing these mechanisms. But much more will be required to improve local governments' accountability and responsiveness to local needs.

Extending the social insurance system, beginning with the urban sector

As noted earlier, further reforms to social insurance programmes are needed to better integrate labour markets as well as provide a social safety net and old age income security. The basic longer-term challenge is to develop nationwide programmes that ultimately cover the entire workforce. The first step, which could be accomplished in the medium term, is to extend coverage to the informal sector of the urban workforce, as well as to individual proprietorships whose participation is now voluntary. This step is particularly needed to provide retirement and other benefits to migrants from rural areas, who make up the bulk of the urban informal workforce. Unemployment and occupational safety benefits could also be extended to the rural sector in the medium term. Development of a rural pension system, however, is necessarily a much longer-term goal that will need to wait until rural income levels have risen to levels more able to finance such a system. Traditional old age support from family, land and personal savings is likely to remain the mainstay in rural areas for the foreseeable future.

Extension of coverage is necessary but not sufficient to establish a nationwide system of benefits. Although the central government has specified ranges for contributions and benefits based on local cost of living and wage rates, the segregation of insurance pools at the country and municipal level has led to wide variations in financing burdens and in benefits paid. Pooling benefits at the provincial level – which the central government has been encouraging – is a minimum step needed to harmonise systems. Equally important are reforms to make pension benefits portable across cities and regions. The minimum time an individual must contribute to the pension fund in a single area before acquiring vested benefits (now ten years) should be lowered, and preferably abolished. Rules facilitating the transfer of pension contributions and rights among organisations within cities, followed by similar rules governing transfers among cities, need to be developed as soon as possible.

Achieving nationwide benefit systems poses many specific challenges for regulatory institutions and processes. The network of labour offices and their social benefit departments will need to be expanded as coverage is extended to the informal sector, and efforts expanded to disseminate information about benefits and rights to workers and

employers. The capacity for enforcement, to ensure that contributions are paid and that labour standards and protections are observed, is likely to need strengthening, particularly as informal businesses are smaller on average than those in the formal sector and have long operated outside the formal regulatory net (OECD, 2005a, Chapter 11).

Development of the pension system is posing challenges for financial regulators as well. Returns on pension contributions have been low due in large part to the restriction of their investment to bank deposits and other safe but low-yielding assets; they will need to increase to support adequate pension benefits. The financial regulators have been expanding the portfolio choices allowed to mutual funds and insurance companies in order to improve the risk-return profile on old age savings. This requires formulation and enforcement of prudential standards and regulations to ensure that risks are properly managed and abuses contained. Allowing further diversification of the institutions' holdings in foreign assets, which could significantly further improve their risk-return profile, will pose further challenges to the regulators.

The critical need for healthcare reform, especially in the rural sector

Spurred by the SARS crisis, healthcare has been given top priority in the 11th Five-Year Plan, which commits to fresh and comprehensive reform aimed at ensuring equity in access and improving cost-effectiveness in delivery. Achievement of the first goal in urban areas will require extension of the employer-based health insurance system for non-government workers to the informal sector. Compliance to ensure that eligible workers are actually covered and the required payments made will need to be improved and benefit pools widened to the provincial level. Restoration of health insurance in rural areas entails both increased government spending and reconstruction of a coherent rural healthcare system. The advent on an experimental basis in several southern provinces in 2003 of a new rural co-operative medical care system marks a start toward these objectives. The authorities have announced their intention to establish this system nationwide by the end of 2008. Government spending on healthcare has been rising as a share of the overall budget since 2002, with much of the spending going to transfers to rural areas to support healthcare. Government outlays will likely have to rise considerably further to achieve nationwide coverage of the rural co-operative system.

The challenges of establishing an efficient healthcare system are especially great in China, because of the legacy of past reform failures and a healthcare industry structure that has changed very little since the 1980s. Hospitals and other providers are mostly state-owned public sector units with opaque ownership and supervision, limited accountability and transparency, overlapping and conflicting responsibilities, and adverse incentives typical of public service units in China. Medical facilities are owned or controlled by a wide range of governments, universities and other institutions subject to a range of inadequately co-ordinated supervisory authorities. The consequence is that the units are accountable neither to public sector mandates nor to the market, and are often operated for the benefit of their staff and management (Hougaard, Osterdaal and Yu, 2008). The provider industry needs thorough restructuring to establish medical facilities more clearly as public agencies, non-profit institutions, or private profit-making businesses as appropriate, with clear mandates as to their objectives and permitted funding sources. Allowing private firms to provide medical services, which is now prohibited, would help to alleviate the present shortage of resources in the sector and improve competition.

The current fragmented system of health regulation also needs to be restructured (OECD, 2008b). Primary responsibility needs to be concentrated with the Ministry of Public Health and its jurisdiction extended to the entire economy. A clearer allocation of responsibilities and accountability needs to be established among the ministry and subsidiary regulatory bodies at all levels of government. Subsidiary regulatory bodies, such as local health authorities, need to withdraw from provision through hospitals or other facilities.

Effective healthcare regulation involves a mix of market and non-market mechanisms. OECD experiences indicate that competition among hospitals can foster cost efficiency, but only if several conditions are met (OECD, 2008b). Compensation from insurers needs to be structured to encourage hospitals to treat as many patients as they able to effectively for a given payment, rather than based on cost-plus or other formulas that do not offer adequate incentives for efficiency. Selective contracting should be allowed, competing suppliers should be available, and purchasers should have adequate information about their alternatives. Establishment of benchmarks based on best or median practice can help in designing compensation formulas. Unnecessary restrictions on the use of medical personnel, which inhibit the ability to use the least cost resources needed for a given treatment, should be lifted. International experience also indicates that hospitals and other providers use drugs most cost-effectively when they operate independently of pharmacies rather than jointly, as is the case in China.

Much trial, error and revision will be needed to establish an effective healthcare system with an appropriate balance between equity and cost containment. These efforts will be more effective if they make use of objective, empirically based, analytical tools. For example, changing market conditions are likely to spur mergers and restructuring among existing providers, which may improve efficiency but which may also restrict competition. Competition policy tools can help monitor how competition evolves and, if necessary, signal when interventions are necessary to contain new anti-competitive practices. Other tools of regulatory impact analysis can help in designing policies to help poorer citizens pay for healthcare without encouraging overuse or at unnecessary cost.

Improving the business environment and economic integration

Despite their apparent success, past policies to develop China's coastal region are not the appropriate model for developing interior regions and the rural economy. The tax preferences and privileges given to coastal provinces during the 1980s and 1990s served mainly to offset constraints imposed by central planning on market and business sector development. With the market economy now established, development of interior regions needs to focus on improving the business environment and on integrating poorer areas into the rest of the economy.

While regional development policies need to be tailored to individual circumstances, OECD experiences suggest a number of lessons, in terms of both what to avoid (Box 1.7) and policies with the greatest chance of success. The basic positive lesson is that policies need to focus on exploiting and developing regional comparative advantages so as to maximise the benefits to the economy as a whole (OECD, 2005c). Regional policies in China have been moving in this direction. In 2004 a more comprehensive strategy was unveiled that sets out the broad outlines for each major region. Along with continuation of the Western Economic Development programme, the strategy calls for restructuring and revitalisation of industry in the old industrial core in the northeast, and for greater

Box 1.7. Pitfalls of regional development: The OECD experience

Most OECD countries have long had policies to develop poorer regions, examples being the programme to develop the Appalachian region in the United States and the effort to develop Italy's southern regions (*Mezzogiorno*). These efforts often have had at best limited success; they highlight pitfalls in once popular development strategies (OECD, 2002, Chapter 21).

- Reliance on large government transfers to regions with severe distortions in the business environment or where co-ordination is inadequate tends to waste resources and is of limited benefit.
- Infrastructure investments made without adequate assessment of future demand tend to be inefficient.
- Growth pole strategies, although once favoured, have not been very successful in practice.
- Fiscal resources need to be concentrated on promoting development rather than supporting or protecting declining industries.
- Policies need to take account of the circumstances of the region to which they are applied rather than to simply replicate measures being applied in more advanced regions. For example, the increasing emphasis on innovation in business development in coastal provinces may be premature in less developed provinces where the key challenge is to develop labour-intensive businesses.

emphasis on targeted policies to foster development takeoff in central provinces, which had received less attention in earlier regional policies (OECD, 2005b).

Infrastructure investment is essential to provide the transportation, communications, and other backbone for business development, especially in the west, but it is not sufficient by itself. As noted in the previous two sections, the burdens of excessive and inefficient regulation, uncertainties about discrimination, and inadequate protection of property are much greater in central and western provinces than on the coast, and typically more than offset the advantages lower wages offer to domestic and foreign investors. They also inhibit the development of local business. Development of interior provinces is further impeded by limited skilled labour and difficulty in retaining and attracting highly educated personnel. Improvement in the local business environment – including local education and training facilities, external surroundings and amenities – is thus equally crucial and could bring substantial benefits to those cities that now lag in these areas.⁵⁴

Improvement in the living standards of the rural population will ultimately require migration of a substantial portion of that population to higher-paying jobs in the cities, along with the development of higher-productivity businesses in the rural sector itself to employ those who remain. Much of the increase in urbanisation is likely to occur in smaller and medium-sized cities, which some evidence suggests are below optimum size (OECD, 2005b). For this to happen, the rural sector needs to be much better integrated into the overall economy than is now the case. A phased elimination of the *hukou* accompanied where needed by central government support to help cities absorb rural migrants would be useful first steps. Reforms to ensure that rural migrants have adequate old age security, either through the pension system or by a clearer claim on their land in their former villages, are also likely to be needed.

The success of regional development efforts will ultimately depend on reforms to improve the quality of governance and to strengthen regulatory institutions and processes discussed earlier. Improvement in the business environment will not occur without substantial improvement in the efficiency of local governments and their accountability to local needs, or without more effective regulatory institutions and tools. A more rational and flexible set of fiscal relations among government levels is essential to improve education and healthcare in rural areas, while rapidly growing cities need to ensure that they have the resources needed to accommodate rural migrants. Above all, regional development demands excellent co-ordination among government levels and among agencies at the local level. The challenge of achieving this co-ordination is all the greater given that it is likely to involve new co-operative relations – for example between city and county authorities, and government authorities in different provinces – that traditionally have not had to co-operate (OECD, 2005c).

Conclusion

Thirty years of reform have transformed China from a centrally planned autarkic economic system, the majority of whose citizens lived in absolute poverty, into a market economy with exceptionally rapid growth, much improved living standards, and a major role in the world economy. The process responsible for this transformation has been unconventional in its sequencing but ultimately based on principles underpinning successful development in other countries. The reform process was most distinctive in the first phase even if it avoided the economic and social upheavals resulting from more sudden transitions elsewhere. While retaining the commitment to socialist dominance, reforms during the 1980s laid the basis for later development of the private sector and the integration of China into the international economy. The second phase of reform was initially dominated by efforts to address the severe imbalances that developed in the first, but these spurred legal and institutional reforms essential to further development of the market economy. The past decade has been especially fruitful in establishing a nearly complete set of legal and regulatory frameworks to underpin development in the future.

Pragmatism – particularly the willingness to make timely corrections to reforms when necessary without abandoning basic objectives – and the fostering of a progressively greater role for the private sector have been critical to the success of the process. Equally important has been the extensive and effective use of international experiences in designing reforms. The reform process has become increasingly comprehensive and sophisticated, and has built up an “infrastructure” of reform bodies and know-how that will be a major asset in the future.

The majority of the basic strategic decisions about the economy’s nature have already been made. The pre-eminence of the private economy and its leading role in development is now firmly established, as is the protection of private property. State enterprises will operate as commercial entities and state, domestic private, and foreign companies will compete on equal terms in most sectors. The real economy, and ultimately the financial system, will become increasingly integrated with international markets. Regulatory bodies are being modernised into institutions that influence the economy by setting and enforcing rules for markets and their participants rather than through direct interventions. The state is likely to retain a greater role in the economy than is now the case across OECD countries, although its scope may narrow further. At the same time, the fundamental issue

of the Party's role in state businesses and some regulatory bodies has not been explicitly resolved.

Many of the fundamental reform steps have been taken, although considerable finishing work remains. Markets and the legal and regulatory framework for business development are well established. Foreign trade and investment liberalisation has gone beyond that of many other developing countries. The central government is now better organised to pursue reforms. The basic regulatory frameworks and institutions have been put in place for the social benefits system and the financial sector. Monetary and fiscal policy instruments are fairly well developed.

Major challenges remain. Relaxing constraints on monetary policy to avoid another boom-bust cycle that would undermine past progress by allowing greater exchange rate flexibility and reform of energy pricing will be particularly important in the near term. In the medium term, three sets of reforms will be crucial to progress in a wide range of areas, including health, education and the environment. The first is extension and strengthening of the rule of law through judicial and other reforms. The second is continued reduction in regulatory burdens in order to improve the business environment, particularly in interior provinces. And the third is a comprehensive reform of relations among government levels to align fiscal resources with mandates and to better define responsibilities and improve accountability among bodies at all levels. Reforms in this area are also crucial to the longer-term goals of developing an old age security system covering the entire population and to narrowing the gaps in development and living standards among regions and between rural and urban areas.

Regulatory reform has now become central to the overall reform process. Economic reform is coming to depend much less on major strategic decisions by the highest government levels and increasingly on implementing measures formulated by regulatory bodies and other agencies at all levels. These measures will need to be continuously reviewed and revised with experience and with further development of the economy. Success in this reform dynamic will depend first on the strengthening, and in some cases establishment, of effective regulatory bodies with coherent mandates, a clear division of responsibilities among organs, and the independence necessary to pursue their mandates. Second, effective reform will require the embedding of sound regulatory principles in regulatory and other policy processes, including transparency, accountability to stakeholders, and minimisation of burdens. And third, objective and empirically based tools will be needed to be developed and incorporated in regulatory processes to weigh the costs and benefits of alternative regulations to accomplish specific goals and to balance competition, efficiency, equity, environmental, and other objectives. Efforts in these three areas are likely to be a major theme of China's reforms in the coming years.

Notes

1. The firms were part of local government departments that were in theory accountable to their national heads and subject to the plan. The geographic dispersal of industry resulted in a much larger portion of small and medium-sized enterprises, and much lower average scale, than found in the FSU and other European socialist economies.
2. The retention within the rural economy of a growing portion of agricultural output promoted diversification of rural enterprises into labour-intensive processing activities much more in line with rural comparative advantage than previously (Naughton, 2007).

3. The agricultural share of the rural workforce fell from 94% in 1980 to 82% in 1985, and from 70% of the overall workforce to 61% over the same period. See Goodhart and Xu, 1996.
4. In practice, a portion of the above-quota output was required to be sold at a “guided” price within a range set by the government, with the remainder sold at a free market price. In 1985, about one-third of above-quota agricultural output (and about the same portion of goods sold on retail markets) were subject to the guided range while the other two-thirds were sold on the open market. See Oppers, 1997, p. 26.
5. However, as numerous analysts have pointed out, a significant portion of FDI inflows originated with domestic Chinese investors who funneled funds through Hong Kong, China and Chinese Taipei (“round tripping”) to take advantage of the tax and other preferences given to foreign-invested enterprises.
6. In 1988 the People’s Congress approved a “provisional” act concerning domestic private enterprises, officially authorising their existence and their entitlement, in principle, to protection of their rights. The constitutional amendment act passed at the first meeting of the Seventh People’s Congress on 12 April 1988 also stressed that “the private economy is allowed to exist and develop within the scope of the law, the private economy is a supplement of the socialist public economy, and the state protects the lawful rights and lawful profits of the private economy and carries out the supervision and management of the private economy.” However, these declarations were not followed up by specific enabling legislation until much later.
7. The incidence of job changes from one employer to another in China’s urban areas was exceptionally low compared to the FSU and other European socialist countries. See Naughton, 2007.
8. TVEs faced harder budget constraints. However, pressures from local governments on bank branches to lend to TVEs encouraged the latter to accumulate debt and blunted their incentives, although to a lesser extent than the SOEs.
9. The progressively higher peak inflation in measured inflation during these episodes is exaggerated by the rising portion of retail sales exempt from controls.
10. However, the surge in inflation during the third cycle did cause widespread discontent, as nominal wages lagged behind the rise in living costs and led to a temporary slowing – and in some cases, retrenchment – in reforms.
11. Under the reform, three-quarters of the value-added tax (the single greatest source of revenue) is assigned to the central government and one-quarter to local governments, while three-fifths of corporate (excluding central government-owned SOEs) and individual income taxes go to the central government and the remainder to local governments. The reform assigned revenues from tariffs and import duties, taxes on central government SOEs, and taxes on financial institutions exclusively to the central government, while local governments are given exclusive control over income taxes on locally owned SOEs, taxes on urban land use and housing, and various land use taxes. See OECD, 2006.
12. According to the analysis in OECD, 2005b, total factor productivity growth fell from an annual rate of 5.6% over 1983-88 to 3.4% over 1988-93. Productivity growth from sectoral change accounted for most of this change, falling from a 2.2% annual rate during 1982-88 to 0.8% during 1993-98; it fell further to an average of –0.3% during 1993-98.
13. The People’s Bank of China did not begin to publish official estimates of bank NPLs until early in this decade. Initial estimates, including the figure in the text, were based on a traditional loan classification using backward-looking criteria and widely agreed to substantially underestimate the true level of bad loans. Official estimates of NPLs from 2003 onward are based on the new loan classification system introduced in the late 1990s, which is broadly in line with international standards.
14. A number of analysts argued that growth actually slowed by considerably more, perhaps to less than two-thirds of the official figures for 1997-2001 (Rawski, 2001). However, revised real GDP growth figures issued based on the 2003 industry census, which included the first comprehensive survey of the service sector, are roughly in line with the original figures for these years.
15. A new central bank law was also enacted in 1995, giving the PBC primary responsibility for regulation of money and credit. Although the Commercial Banking Law was supposed to end SOCBs’ non-commercial lending, in practice they remained obligated to continue to lend to SOEs that were already delinquent on their past loans to ensure that employment was maintained. The need for this unofficial policy lending began to decline as alternative means for supporting surplus SOE workers were developed and as the social insurance system developed.

16. At least at first, privatisation was not an explicit goal because of its political and social sensitivity. Some of the “let go” SOEs were converted into collective form, although in most cases it was transitional.
17. The decline continued, and by 2006 there were less than 15 000 SOEs, about half the number in 2001. The transformation produced new hybrid ownership forms, such as state- and collectively-owned enterprises with mixed ownership, which greatly complicated statistical classifications by ownership type.
18. The 1995 Law also mandated the divestment of trust and investment companies that had been acquired by banks but that had been used as a channel for speculative investments in the stock market and real estate.
19. The rationale was that the Commercial Banking Law and creation of the policy banks had freed banks of the obligation to make policy loans. In practice, the SOCBs remained obligated to continue lending to non-viable SOEs.
20. Inflows of FDI accounted for an average of 7.4% of gross domestic investment during 2002-06, and its average growth rate was below that of total gross investment. China’s exports are heavily import-intensive, so that the contributions of net exports to real GDP growth are less than the export/GDP ratio might suggest. Net exports contributed around or slightly less than one-fifth of GDP growth in 2004 and 2006, although the contribution was higher (about one-third) in 2005.
21. Recent studies suggest that China’s potential growth rate is in the range of 8-10%, indicating that the gap between potential and actual output has almost certainly narrowed since 2006. See OECD, 2005b.
22. However, formal analyses of whether China’s currency is undervalued have yielded mixed results. See, for example, estimates reviewed in Dunaway and Li (2005), which cover the period 2000-04 and range from no undervaluation to nearly 50% undervaluation. Estimates based on similar methodologies and more recent data would, however, very likely increase the presumption of undervaluation.
23. Mobility of capital among China’s regions was severely restricted for much of the reform period. Controls on bank lending during the first half of the period largely prevented transfers of funds gathered from savers in one region from being allocated to other regions, especially if they were in the interior. Rural financing has depended on institutions distinct from those serving urban areas and most of industry, and its isolation was increased by the pullback from rural lending by the SOCBs in the late 1990s.
24. However Boyreau and Wei (2004) provide evidence that capital mobility may have declined.
25. Chapter 3 warns, however, that the competition authority needs to be able to notify the agency level above that of the offender since the local competition authorities, which are administratively subject to local governments, tend to be reluctant to do so.
26. The main concern is that transactions carried out outside China and not involving any Chinese-owned entity may still trigger scrutiny.
27. NDRCs role is focused on price fixing, predatory pricing, and related abuses in prices, while MOFCOM focuses on merger review. SAIC has broad authority over monopoly and other anti-competitive practices.
28. Under the 1994 law, a minimum of 2 owners were required to form a limited liability company, and a minimum of 50 shareholders to establish a joint-stock company. Authorisation for single-person limited liability companies has been controversial because of concerns that individuals would use its protection to avoid liability for abuses. In part to reduce this risk, the new law specifies that an individual can establish only one single-person limited liability company. The minimum capital requirements for incorporation under the 1999 law are exceptionally high by international standards: between 11 and 55 times 2005 per capita GDP for limited liability companies, depending on their sector; and more than 1 000 times per capita GDP for shareholding companies. The new law cuts the capital requirement for shareholding companies in half (from CNY 10 million to CNY 5 million), and sets a uniform minimum for limited liability companies of CNY 30 000, or about 1.5 times annual per capita GDP.
29. Notably, the new company law allows the total votes to which a shareholder is entitled (*e.g.* equal to the number of directors to be chosen) on a single candidate (“cumulative voting”). This system, which increases the ability of minority shareholders to elect at least one member of each board, has been adopted in a number of OECD economies (Wang and Huang, 2006).

30. Under the old law, creditors were not allowed to be paid or the company assets liquidated until back wages, taxes, and social insurance contributions were restored. This effectively blocked resolution in many cases.
31. The law reaffirms exclusive state ownership of all land not owned by agricultural collectives, natural resources, major infrastructure, and the radio spectrum, while collectives are the legal owner of all agricultural land. The prohibition on unilateral alteration of land use contracts addresses periodic abuses that have occurred when local governments or leaders of collectives have sold agricultural land use rights to commercial or other interests without the permission of or compensation for the farmers legally holding the rights.
32. China's average tariff rates fell considerably during the 1990s due to the exemption (for foreign-invested exporters) from duties on imported inputs. The WTO agreement mandated a further reduction in the average tariff on agricultural goods from 18.9% just prior to accession to 15% by 2005, and in the average tariff on industrial goods from 14.8% to 8.9% (see OECD, 2002, Annex 1).
33. The phasing out of the multi-fibre agreement was conditioned by China's agreement to allow its trading partners to impose quotas against its exports in case of a "surge" that posed unacceptable risks to the domestic industry of the importing country. This surge provision has since been used by the United States against imports of Chinese-made sleepwear and has also been invoked by several European countries. Overall, China's commitments to opening its internal markets appear large relative to the concessions in received in return as compared with prior trade agreements.
34. Greene *et al.*, 2006 also cites evidence of the rising quality of labour inputs in Chinese exports to OECD economies.
35. Indeed, efforts to reduce administrative burdens and increase transparency were well under way in Shanghai and the major southern coastal cities before China's WTO entry, and seem to have helped spur the efforts of the central government (see OECD, 2000).
36. Chinese corporate governance has adopted the dual board model found in Germany and some other continental European countries, under which the board of directors oversees the senior management while a separate board of supervisors, which includes representatives of the employees and (sometimes) other stakeholders, oversees the board of directors. In practice, as a number of observers have pointed out (OECD, 2002), the role of the supervisory board in China has been somewhat ambiguous, and in practice its functions have sometimes overlapped those of the board of directors.
37. Until 2001, new listings were allocated administratively, with SOEs in certain sectors and regions given preference. Approval authority was then ceded to a listing committee composed of outside experts and based (mostly) on objective indicators of firm performance and quality. This change has fostered greater "competition" in getting listed. However, a large backlog of companies that are approved but not yet listed has developed, and the authorities seem to continue giving preference to companies in priority sectors when it comes to determining which companies are allowed to make their initial offerings first (see OECD, 2008a).
38. Much of the evidence on the impact of stock market listing is based mainly on data from the latter half of the 1990s and first several years of this decade, and therefore may not capture benefits that took longer to become apparent.
39. Under the reform, holders of state shares in the listed companies were required to offer compensation to holders of the tradable shares, who had to approve the plan. Most listed companies had adopted conversion plans by the end of 2007. However, shares have only gradually become tradable because the authorities imposed a lockup period requiring larger holders to wait up to three years before selling their holdings. This lockup was imposed to cushion the impact on market prices and prevent the adverse reaction from investors that had aborted two earlier preliminary attempts at reform in 1999 and 2001 (OECD, 2008a and Beltratti and Bortolotti, 2006).
40. The first three reforms, in 1982-83, 1988, and 1993 focused on downsizing, separating government departments from SOEs and increasing the authority of organs with responsibility for aspects of the overall economy ("comprehensive departments"). The 1993 reform also established the civil service. In 1998, the government undertook a more profound re organisation – reducing the number of government departments from 49 to 30, cutting a large number of bureau-level staff, and including plans to downsize the central government civil service by 50% and local government staffing by 20-30% over several years.
41. The authorities have relied increasingly on "window" guidance on bank lending. This guidance is officially intended for prudential reasons to caution banks against excessive lending to real estate

- and other sectors that may be becoming overinvested; in practice it seems to have been used to help restrain overall bank lending.
42. China's previous exchange rate regime was officially registered as one of managed floating with the International Monetary Fund, but in practice the RMB had remained pegged at 8.27 to the US dollar since 1995. The new regime is similar to that adopted by Singapore after the 1997 Asian financial crisis. Malaysia adopted a similar system shortly after the Chinese announcement (Ogawa and Sakane, 2006).
 43. The RMB rose on average by 0.7% per month during 2007-08, compared with 0.3% from July 2005 to the end of 2006.
 44. Participation in each programme is limited to licensed institutions meeting the regulatory conditions. The QDII programme has been managed rather conservatively, with an initial global limit of USD 10 billion that was raised to USD 30 billion at the end of 2007. The conditions favour insurance companies and mutual funds over banks and securities firms in order to foster longer-term investments, and until recently funds invested were subject to a delay of several years before they could be repatriated. The QDII programme has been expanding rapidly since its inception: 70 Chinese institutions participate with an aggregate investment total of about USD 30 billion by mid-2008. The authorities have also recently taken steps to increase the amount of RMB that individuals can convert into foreign exchange for investment in selected overseas stock markets and for education and other personal purposes. For further details, see OECD, 2008a.
 45. More specific recommendations for further steps that might be taken are given in OECD, 2008a.
 46. The SOCBs now account for just over 50% of total commercial bank assets, compared to about 58% in 2003. The dominance of large institutions is likely to be accentuated by the creation of the Postal Savings Bank in 2007 and by the planned transformation of the China Development Bank into a commercial bank. A large state-owned company accounts for nearly half of the market for life and non-life insurance. The restructuring of the securities industry has also increased concentration into several large state-owned companies.
 47. Lending by several SOCBs to private domestic enterprises has risen noticeably. According to their annual reports, loans to this segment by the Industrial and Commercial Bank of China and China Construction Bank have risen to 15.1% and 17.2% respectively of their total corporate loans in 2007, compared to 11.5% and 11.8% respectively in 2005.
 48. For example, Leigh and Podpiera, 2006 cites evidence that foreign bank participation helps to improve the capabilities of domestic banks and foster development of the banking market.
 49. For example, the authorities recently announced plans to encourage foreign reinsurance companies to enter the Chinese reinsurance sector, which is crucial to developing products to insure against very large risks arising from natural disasters or other calamities, a domain that has remained underdeveloped due in part to state-imposed dominance by a single SOE insurance company.
 50. See for example "Reform of the Energy Pricing System Crucial", www.china.org.cn/english/GS-e/236930.htm. The IEA (2006) report further notes that a "... key issue is that the current [pricing] framework does not encourage investment in end-use energy efficiency as an alternative to supply-side investments" (p. 94).
 51. As the IEA report notes, pricing reforms need not and should not wait for establishment of competition, although the measures initially adopted will need to be adapted as competition is introduced.
 52. This is underscored by a case in 2003 in which a local-level judge ruled against a local government agency, leading to conflict with provincial-level superiors and a controversy that received wide attention in the Chinese press ("A Judge Tests China's Courts, Making History", *New York Times*, 28 November 2005).
 53. This will require some combination of greater responsibility for certain expenditures on the part of the central government and higher levels of responsibility within provinces, along with greater devolution of fiscal resources to lower levels. However, international experiences indicate that there are a variety of ways of rationally allocating fiscal responsibilities and revenues across government levels, and that the best arrangement is very much a matter of a country's history, constitutional and legal arrangements, and other factors.
 54. The most recent World Bank Survey of the investment climate of Chinese cities estimates that raising the education and technical training, healthcare, and environmental quality of the bottom quintile of cities in China to the levels of the most advanced cities could increase the business productivity of the former by as much as 25% (World Bank, 2006).

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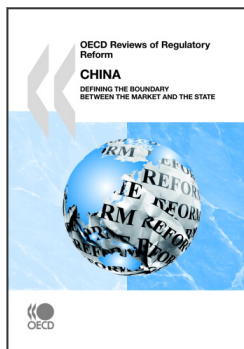
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