

## Executive Summary

The transition to a market economy in the People's Republic of China is among the great economic success stories of modern times. Since the beginning of economic reforms in 1978, real GDP growth has averaged almost 10% annually, a performance that compares favourably to that of the prior growth champions – Japan and Korea. China has become the world's third largest economy, its number two exporter, and its leading manufacturer. Living standards of all segments of the population have risen markedly over the past three decades and poverty has fallen from over 50% at the beginning of reforms to below 10%.

Regulatory reform – changes to regulatory institutions, methods, and practices – initially played a very limited role in China's economic reforms, but has now become central. This reflects the increased emphasis in the overall reform process on the ongoing formulation, implementation and adaptation of the laws and regulations needed to sustain an efficient market economy. High-quality regulation is very important to the success of such efforts. This first *OECD Review of Regulatory Reform in China*, carried out in partnership with the Government of the People's Republic of China, examines China's regulatory reform progress and its contribution to the country's development during the economic reform period. It reviews China's progress in competition policy and market opening as well as progress in establishing effective regulation of infrastructure sectors, with special attention paid to electricity and to water supply and sanitation. It also provides suggestions for consideration by China's reformers based on experiences of OECD member countries. As indicated in the remainder of this summary, China's regulatory reform has made impressive progress over the past decade and is gaining momentum. Much remains to be done, but a very good foundation has been laid.

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### *Institutional development and evolving reforms*

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The first half of China's economic reform period was marked by rapid market development and opening largely within pre-reform formal legal and regulatory structures, a process that has become known as “growing out of the plan”.<sup>1</sup> The achievements during this period laid the foundation for the institutional developments that were to come later. Restoration of individual farming through the “household responsibility system”, along with increased agricultural prices, led to a dramatic rise in agricultural productivity and increase in household savings. These in turn supported increased capital accumulation and freed up workers to fuel the remarkable growth of township and village enterprises. This transfer of workers from lower-productivity jobs in agriculture to higher-productivity work in rural industry became an important driver of China's growth during the 1980s.

The gradual freeing of agricultural and industrial prices spurred the growth of markets. China's opening to international trade and foreign investment beginning in the early 1980s

(which came earlier and went farther than that of Japan and Korea during their rapid growth periods) was to prove increasingly beneficial to its development. All these developments occurred while state ownership continued to dominate most of industry and all but the smallest-scale services; while private enterprises remained severely restricted; and while township and village enterprises (TVEs) continued to operate under pre-reform legal provisions, although their practical operation was quite different. Moreover, despite the creation of a central bank and several commercial banks, credit allocation remained strictly subject to state planning.

The need for institutional development and transformation became increasingly apparent by the early 1990s, as serious imbalances and strains accumulated. The business sector had become fragmented between ownership segments – state, collective, foreign, and domestic private – operating under different sets of rules. Inequalities among regions were growing, as coastal regions benefited most from the growth of TVEs and opening to foreign trade and investment. Businesses, including state-owned enterprises (SOEs), had greater autonomy but weak governance structures, and internal controls limited their capabilities and incentives to function effectively as commercial enterprises. Incentives were further weakened by the allocation of credit under state planning rather than according to strict commercial criteria, and by the lack of mechanisms to ensure that debt was repaid. The resulting “soft budget constraint” was substantially responsible for large and growing debt loads and losses of SOEs, and to a lesser extent of TVEs, as well as increasing non-performing loans (NPLs) of the banking sector. Limited control of credit led to a series of inflationary boom-bust cycles. The fourth and most serious of these cycles, during 1992-94, left massive excessive capacity and inventories in industry. The already severe financial problems of SOEs and banks were at critical levels by the latter half of the decade.

These problems led to a major effort to build the formal frameworks and institutions to support and regulate the market economy. Between 1993 and 1995, four key laws were enacted: an anti-monopoly law; a company law providing for limited liability and joint-stock companies; a commercial banking law mandating commercial criteria as the basis for lending; and a labour law. Much reform was focused on dealing with the financial problems of SOEs and the banks, and ensuring that they did not recur. Beginning in the second half of the 1990s, SOEs began a major restructuring and downsizing. This included a massive reduction in employment – leading ultimately to a reduction of their workforce by almost one-third – and the divestment of small and medium-sized SOEs. The government began to provide financial assistance to banks and strengthened regulation and oversight of their activities. These efforts spurred broader reforms, for example to extend and strengthen unemployment and other social insurance; to develop an old-age pension system; and to strengthen bankruptcy mechanisms to allow failing companies to exit and to free resources for more efficient use. China also began to partially open electricity and other infrastructure services to outside participation and to address growing problems of environmental deterioration and regional inequality.

A new development paradigm emerged, based on two principles. The first was that all business segments, private as well as collective and state owned, were to be allowed to compete on a level playing field in the market, save for sectors deemed critical to national security or other essential needs. The second was that the state would seek to regulate the economy mainly by formulating, implementing and enforcing rules for markets and their actors rather than by directly intervening in pricing and resource allocation. The development of this paradigm was spurred by the run-up to accession to the World Trade

Organisation and reinforced and broadened by its achievement in 2001. The constitutional amendment recognising the legitimacy of private business and its role in the economy, enacted in 1999, was followed in 2004 by a further amendment explicitly mandating protection of private property.

Reform of regulatory institutions and practices has become a key theme of economic reform in this decade. The major government reorganisation instituted in 2003 marked a formal and decisive embrace of market-based regulation in place of economic planning, and incorporated the integration of domestic and foreign economic policies into the government structure. In 2006, four key laws that had long been in preparation took effect. These included a much-updated and improved competition law that explicitly addressed key issues, including administrative abuse, that had been inadequately addressed by the previous anti-monopoly law; and a comprehensive bankruptcy law that drew on international experiences. Amended company and securities laws also came into effect and mandated formal governance structures for joint-stock enterprises, rules for the issue and trading of securities on the exchanges, and provisions to protect investors and minority shareholders. Key regulatory institutions were created or extensively restructured and reformed. These include the China Bank Regulatory Commission, created in 2003 to regulate and supervise commercial banks and trust companies; the China Securities Regulatory Commission, which was originally created in 1992 but acquired the major responsibility for all securities regulation in 2004; and the State Asset Supervisory and Administration Commission (SASAC), established in 2003 to exercise the state's ownership in remaining SOEs. The authorities have made skilful use of international experiences and norms in designing and implementing these reforms.

The legal and regulatory reforms implemented over the past decade have already brought extensive and substantial benefits. For example, the reform and restructuring of the financial regulatory agencies have been very important to the success of efforts to restore the financial solvency of banks and securities companies, and to improve their governance and internal controls. These accomplishments are providing the foundation necessary to allow financial institutions to diversify their services and products to better meet the economy's needs.

The market opening and other reforms driven by China's WTO entry have spurred not only a boom in foreign trade and foreign direct investment (FDI), but also improvement in their quality. For example, China has become the world's leading exporter of information and communications equipment, and its firms are moving beyond simple assembly of imported parts into processes requiring higher skilled labour and greater technology inputs. 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 largest benefit from WTO is likely to result from its impetus to the broader economic reform process. The changes in laws and regulations mandated by WTO on competition, intellectual property rights protection and other areas are as essential and potentially beneficial to domestic businesses as to foreigners.

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### *The ongoing process of regulatory reform*

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China's economic reforms have made much progress, but considerably more remains to be done. With many of the major strategic decisions and steps having been taken, the emphasis is now shifting toward implementing the reforms through an ongoing process of legislation, formulation of regulations, review, revision and, where necessary, removal of existing laws and regulations. Regulatory reform to improve the quality of these processes is now becoming crucial to ensuring that the major reforms are successfully sustained over time.

The Review documents the impressive and growing progress on regulatory reform that has been made in China. It notes that international experiences, including those of OECD members, point to several general principles for effective regulation. Effective regulation depends on the existence of regulatory bodies with clear mandates, authority, and accountability. Regulators need to be independent – not simply (or even most importantly) in a formal sense, but free from interference from regulated businesses and other government agencies. Effective regulation focuses on making markets work effectively, by fostering efficiency and innovation, promoting sustainable development, and maximising benefits to end-users. It is best separated from the pursuit of industrial policy or other government mandates. Regulation is a dynamic process in which transparency in rule formulation, effective dissemination to stakeholders and mechanisms for consultation and appeal are essential. It is also an intensely empirical process requiring detailed knowledge of market conditions and trends and tools for assessing the impact of particular regulations and their costs and benefits. Successful regulatory reform embeds these principles and practices in the decision making of each regulatory agency and its components.

The Review highlights a number of areas where China's still-young regulatory institutions and processes could be further improved. Regulatory authority in China is often fragmented across a number of bodies, some of which also have broader mandates. Both conditions can weaken regulatory responsibility and blunt its focus. Inadequate co-ordination among government bodies at the national and sub-national levels is a widespread and ongoing problem, and has led to unclear, duplicative, and often conflicting efforts in a number of areas. While improving, the ability of those affected to know and understand the regulations to which they are subject, to be consulted in their formulation, and to appeal adverse rulings is still limited. Judicial enforcement of laws and regulations tends to be costly and overly unpredictable, particularly in cases where a government body is a party to the litigation. Implementation is sometimes further complicated by an emphasis in formal legislation on general principles that can engender ambiguities about how the law is to be applied in practice. While China has a long history of experimenting with reforms before their nationwide adoption, the systematic use of empirical tools to measure the effectiveness of regulations once they have been imposed is still fairly limited. The Review makes a number of specific recommendations for improving regulatory capabilities in China, including the following.

- Creation of a distinct body or network among key regulatory institutions to promote high-quality regulation throughout the government. Such a mechanism has proved an effective catalyst for regulatory reform in a number of OECD countries.

- Development of procedures to ensure transparency in rule formulation and application, including consultation with key stakeholders.
- Establishment of concrete mechanisms to simplify and improve regulations, such as “one-stop” windows to consolidate regulatory applications and approval; and “sunset” provisions requiring that certain regulations be reviewed periodically to determine if they should be revised or eliminated.
- Development and promotion of the use of empirical tools to measure the impact of specific regulations and their costs. In OECD countries, regulatory impact analysis comprising a set of tools, such as cost-benefit analysis, is increasingly used to ensure that regulatory impacts are achieved in a cost-effective manner.

Regulatory reforms to promote competition and open markets can have high payoffs to all sectors of the economy, and have been a major focus of reform in many OECD countries. Their experiences underscore that sustaining markets that are open and competitive is an ongoing process involving not only actions against collusion and other traditional anti-competitive practices, but also measures to ensure that regulations do not unnecessarily discriminate against certain participants or pose unnecessary burdens. Complex, opaque and often poorly enforced laws and regulations have long been a concern to China’s trading partners and foreign investors, and were a major element in China’s commitments under the WTO. While China ranks more favourably than other large emerging economies in international surveys on the ease of doing business, it ranks lower than most other Asian emerging economies.<sup>2</sup> China’s domestic businesses stand to benefit at least as much from simpler and more transparent regulation, less burdensome compliance, and more effective enforcement of laws on intellectual property rights and other areas. Steps to achieve these goals could also help greatly in addressing another major concern of China’s policy makers – corruption – since complex and opaque regulations increase opportunities for abuse.

The Review highlights the important efforts China has made in recent years toward strengthening competition and openness. The law on government procurement adopted in 2003 prohibits unreasonable discrimination among suppliers, including foreign suppliers. Extensive efforts are being made to review and simplify regulations and to harmonise China’s domestic product and other technical standards across sectors and, as appropriate, with international norms. The Review notes that China has gone further than many WTO members in improving regulatory transparency: it has established an inquiry point to provide authoritative clarification of laws and regulations affecting international trade, and has agreed to publish all laws and regulations in at least one official WTO language in addition to Chinese.

These efforts are at an early stage; they will need to be further clarified, refined and broadened over time. The new competition law leaves some important questions unanswered, such as application of the law in industries now designated as vital to national security, that will need to be resolved through further measures or judicial decisions. The law’s prohibitions on administrative abuses could be a powerful tool to combat local protectionism and promote more efficient and fair regulation, but its enforcement capabilities remain to be tested. Responsibility for enforcing the law is now divided between three major government agencies with broader responsibilities,<sup>3</sup> whereas the majority of OECD countries have found that lodging the authority with a single dedicated agency tends to be more effective.

OECD experiences suggest a number of steps that could help make competition and market opening reforms more effective.

- Develop and institute a broader competition policy framework and its incorporation throughout regulatory policy as a means of ensuring that regulations promote genuinely open access and efficiency. OECD members are increasingly using competition policy to provide means of systematically reviewing the impact and costs of laws and policies that affect market conduct.
- Broaden efforts to reduce regulatory complexity and to identify and correct constraints on enterprise activity that are more stringent than necessary to achieve policy goals.
- Further reduce entry barriers to service and infrastructure sectors by foreign and, where needed, domestic businesses. This would help to improve competition, efficiency, the variety of products and services offered, and fostering of innovation. In particular, liberalisation of remaining limits on foreign ownership of domestic businesses in the financial sector would help improve the quality as well as quantity of foreign investment.
- Strengthen efforts to harmonise China's technical standards with international standards and streamline conformity procedures, in part by developing the capacities of domestic accreditation bodies. Consideration might also be given to allowing qualified foreign-owned conformity assessment bodies to operate in China.
- Develop and incorporate in regulatory processes objective, empirical tools to evaluate the impact of regulations and their costs and benefits. Regulatory impact analysis and other tools used by OECD member regulators may be useful in this effort, although they will need to be adapted to China's circumstances.

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### *The special challenge in infrastructure sectors*

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Infrastructure sectors present particular challenges as well as risks for regulatory reform. Formerly regulated entirely as natural monopolies, these sectors have been gradually and partially deregulated in OECD countries. The aim has been to introduce competition into those segments where it is viable while continuing to regulate segments where competition is not viable and monopoly provision is most efficient. For example, in the electricity sector, transmission is a natural monopoly since it is most efficient to have a single grid; but competition is feasible in electricity generation since many providers can connect to the single grid. China is in the process of undertaking similar reforms in its energy sectors, including electricity, as well as in water provision and sanitation and telecommunications.

However, while the principle may seem simple, practical introduction of multiple providers in competitive segments while maintaining regulation of pricing and other conditions in the monopoly segments has proved to be a complex task fraught with pitfalls. (Some non-infrastructure sectors, notably healthcare, also involve a mix of elements that can be left to competitive markets and elements that require regulation – and similar difficulties arise.) Infrastructure segments are closely linked, so that distortions in one segment can seriously impair performance in the others. Since infrastructure industries are critical suppliers to other industries and services, their performance has a major bearing on the economy's overall efficiency and development. Thus, while the benefits of successful regulatory

reform of infrastructure industries are large, so too are the potential costs of reforms that are badly designed or poorly executed.

Deregulation of infrastructure sectors in OECD member countries has a record containing notable failures as well as successes. Examination of these experiences offers some insights that may be useful for China's current infrastructure reform efforts. OECD experiences especially underscore the need for high-quality regulatory institutions and processes.

- Infrastructure reform is an adaptive process rather than a one-time, “big bang” event. It needs to be shaped by the particular circumstances of the industry and economy in which it occurs. The quality of the institutional design of reforms and the timing of their implementation are critical to establishing the credibility of the regulators and preventing their capture by the regulated or other outside interests.
- Introduction of competition requires strong effective regulation to ensure that benefits accrue to end-users. Regulatory interventions need to be carefully co-ordinated along the supply chain.
- Regulators need to be capable of balancing competing considerations, such as environmental or safety considerations *versus* technical efficiency. Empirical tools to evaluate impacts and the trade-offs involved, such as those in regulatory impact analysis, are likely to be particularly needed in infrastructure regulation.
- Because of information asymmetries, high-powered incentive schemes are the most efficient tool for regulating infrastructure service activities. Effective incentive systems in turn call for regulators who have a very clear understanding of industry conditions and a high degree of credibility.

The Review's examination of China's ongoing regulatory reform of electricity and of water supply and sanitation further highlights these points and offers other potential insights. Formal deregulation of China's electricity sector began in 2002 with the creation of five regional power generation companies and two transmission companies designed to operate as regulated monopolies. The State Electricity Regulatory Commission (SERC) was created as the main regulator over electricity, and is expected to ultimately assume authority over other energy sectors. Authorities plan to introduce multiple competitive providers in each of the geographic regions, and to gradually allow prices to be more responsive to market forces. The regulatory reform process is very much a work in progress, and the Review highlights several areas for improvement and some potential pitfalls.

One of the most pressing needs is to reform the pricing of electricity as part of price reform in the overall energy area. Failure of electricity prices to keep in line with energy and other costs has led to erratic investment and periodic shortages in electricity supply, most recently during 2003-06. Retail prices for electricity are below those in most OECD countries and probably lower than necessary to promote efficient use and adequate conservation. Comprehensive reform is likely to be needed to establish pricing that reflects costs in all components, from extraction to refining and distribution, and to end-users. The Review suggests a number of steps for consideration in order to achieve this goal, as well as to strengthen the broader process of electricity reform.

- A key priority is to complete the building of a sound legal and regulatory framework. Consideration should be given to following the practice in most other countries of

according to the primary authority for electricity pricing, which now lies with the National Development and Reform Commission, to the sector regulator, namely the SERC.

- Regulation needs to foster investments in new transmission and other facilities that are economically viable and efficient in terms of their scale, efficiency, technology, and use of alternative fuels.
- Clear and effective policies and instruments need to be developed and embedded in the electricity regulation process to ensure that it promotes and does not hinder broader longer-term objectives, notably those for conservation and the environment.
- Introduction of competition into generation, while an important longer-term goal, needs to be done with care and rigorous monitoring and oversight. Inelasticity in electricity supply and demand and other factors make electricity markets particularly vulnerable to collusion and other anti-competitive practices, as well as large price swings. Fragmentation in China's transmission grid tends to add to the vulnerabilities. Maintenance of effective competition requires highly capable regulators with detailed knowledge of market conditions and analytical tools to detect changes in those conditions.

The high degree of decentralisation of water supply and sanitation and its importance to health, environmental and other policy objectives, present formidable challenges of co-ordination among a myriad of providers, regulators and government agencies at the central and sub-national levels. Effective regulators are particularly important because the nature of water supply affords consumers less choice among providers than in electricity or gas.

China has been refining its regulatory framework, institutions and practices in water and sanitation for many years, and has made significant progress. Outside (including foreign) companies have become key players in water provision, operating under build-operate-transfer and other arrangements to share costs and risks along with local governments and the providers. But much remains to be done. As in electricity, an important objective is to develop pricing mechanisms that adequately reflect costs, in order to encourage investment and also promote development and maintenance of clean water supplies. Water is inefficiently used in agriculture due in part to inadequacies in pricing, and end-users in urban areas are generally not charged directly for sewerage and water treatment costs.

Based on the experiences of several OECD members, the Review makes a number of suggestions to improve regulatory effectiveness in China's water sector:

- Better define, where necessary through legislation or new regulations, the roles and responsibilities of the central and local government bodies involved with water regulation, including water cleanliness and pollution control.
- Establish national water quality and environmental standards that are consistent with international norms. Establishment of a river basin approach to support and co-ordinate efforts of local authorities would help to ensure effective implementation of the standards.
- Develop and improve monitoring and evaluation capabilities and procedures, and improve public availability of information. These steps would help to establish a more predictable environment for investment in the sector and provide feedback to regulators when problems arise.



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### *The links to success with other reforms*

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Regulatory reform is increasingly important to other economic reforms under way in China. Improvement in rural healthcare, and ultimately reform of the entire healthcare system, present formidable regulatory challenges to contain costs and deal with the adverse incentives and resulting inefficiencies that have afflicted China's system (as well as those of OECD countries). Development of the pension system will require high-quality financial regulation to ensure that financial institutions can provide the savings vehicles needed for old-age security without incurring undue risks. The Review observes that the success of China's efforts to develop interior regions greatly depends on regulatory and governance reforms to improve the local business environment.

The success of regulatory reforms is also dependent on progress in other reform areas. For example, the Review suggests that further reductions in the scope of the SOE sector would not only help to improve efficiency in industry, but also facilitate improvements in the quality of supervision of remaining SOEs by SASAC. Macroeconomic stability, supported by effective and flexible monetary, fiscal and exchange rate instruments, is very important to ensuring that the payoffs from regulatory reforms are realised.

The Review highlights two areas that are likely to be especially important to further progress with regulatory reform. The first comprises efforts to strengthen the rule of law through judicial and other reforms. Numerous studies of China's economic reforms, including this Review, have stressed the importance of improving enforcement of laws and regulations. Judicial interpretation will be a key element in the process of clarifying laws and regulations, and is likely to involve far more proceedings in which government agencies are parties than in the past. Efforts now under way to improve the qualifications and training of judges and other officials in the judiciary will help to improve enforcement, but further efforts may be needed to better insulate the judiciary from undue interference, including from government and political officials.

The second area that will be critical to the success of regulatory reforms is comprehensive reform of relations among central and sub-national governments. The chapters in the Review highlight the obstacles to reform often posed by conflicting and inconsistent mandates among agencies at different levels, and the difficulty of ensuring that local government regulators and other agencies effectively implement national policies. The need to clarify responsibilities and develop mechanisms to improve accountability and oversight is a recurring theme not only in this Review but also in other studies of China's regulation and governance.<sup>4</sup>

However, the Review suggests that success in this area will require more than new laws and administrative decrees. China's highly but unevenly decentralised fiscal system has led to large gaps between expenditure mandates and the resources needed to carry them out at the local level, particularly in interior provinces. These gaps engender conflicts in the mandates of local officials, in which conformity to one set of central government requirements can interfere with other obligations. Thorough reform of fiscal relations among government levels is thus a pressing need that is likely to be important to the success of future regulatory as well as other key reforms in China.

**Notes**

1. Barry Naughton (1996), *Growing Out of the Plan: Chinese Economic Reform 1978-1993*, Cambridge University Press.
2. China ranks more favourably than its overall score in the World Bank survey when it comes to ease of registering property, conducting international trade and enforcing contracts. However, its rank on the ease of establishing a new business was in the lower quarter of countries surveyed, and its rank in ease of obtaining licences was near the bottom. See the World Bank, *Doing Business: 2008*.
3. These are the State Administration for Industry and Commerce, the Ministry of Commerce, and the National Development and Reform Commission.
4. For example, the OECD reports on *Governance in China*, 2005 and *China in the World Economy: The Domestic Policy Challenges*, 2003.

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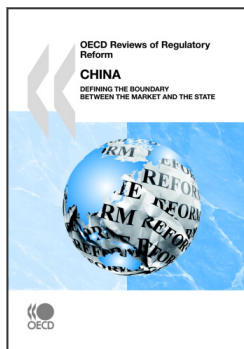
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