

**Asian Development Bank  
and the  
People's Republic of China:  
Partnership  
in the  
Governance Sector**

**Governance in PRC**

Decisions in 1978 to integrate the economy with the world economy ('the open door policy') and in 1992 to replace central planning with a market economy have had a profound impact on PRC's development management systems and institutions. PRC's accession to the World Trade Organization (WTO) in 2001 will also result in systemic change especially in areas such as law and regulation, corporate governance, and so forth.

During the past two decades, PRC has made substantial progress in the process of reform. The country has also tackled the problems of reform of the state-owned enterprise (SOE) system by granting enterprises more autonomy, re-structuring them, and reforming their ownership systems. The Government is now more accountable through a variety of mechanisms including the 'cadre' responsibility system, use of internationally benchmarked auditing and accounting systems, and a fierce campaign against corruption. Public policy making is more transparent and participative through the use of public hearings and variety of other channels. Reform of the legal system and the judiciary has increased predictability. PRC's emerging civil society is becoming an active if junior partner in the delivery of public services.

**ADB's Experience in PRC's Governance Sector**

The Asian Development Bank's (ADB) experience indicates that sustainable development depends on the quality of decisions made toward development and reform, and also on the manner in which these decisions are taken and carried out. In 1995 ADB members reached a consensus to apply this fundamental lesson in a more systematic way to ADB's overall operations. This policy stresses the importance of 'governance', the core elements of which are accountability, participation, predictability, transparency, and efficiency and effectiveness.

### **Box 1: The Four Elements of Good Governance**

#### **Accountability**

Accountability is defined as the imperative to make public officials answerable for government behavior and responsive to the entity from which they derive their authority. This means that a framework must exist that articulates goals, establishes incentives towards the desired outcomes and monitors progress towards this end.

#### **Participation**

The principle of participation derives from the normative principle that people are at the heart of development. They are not only the ultimate beneficiaries of development, but are also the agents of development. Since development is both for and by people, they need to have access to the institutions that promote it.

#### **Predictability**

Predictability refers to (i) the existence of rules and regulations, and policies to regulate society and (ii) their fair and consistent application.

#### **Transparency**

Transparency refers to the availability of information to the general public and clarity about government rules, regulations, and decisions.

Source: ADB Governance Strategy, 1995

Governance has become one of the three pillars of ADB's Poverty Reduction Strategy. Without governance, efforts at reducing poverty will not be effective. Poverty reduction requires economic growth and effective markets, which in turn depend on a basic foundation of capable institutions and governance practices. ADB has supported efforts to enhance governance in a number of areas for many years. These include public expenditure management, public administration reform, legal system reform, public service delivery, public accountability (including anti-corruption work), the interface between the public and private sectors, and the role of civil society.

ADB has been involved in many of these areas in PRC. Since PRC became a member country in 1986, ADB has provided assistance to address governance issues that are related to its operations in PRC. ADB's most recent technical assistance work has focused on public administration, legal and regulatory reform, public service delivery, accountability, public-private interface, and public finance management. Specifically, ADB has supported a number of efforts to strengthen public administration reform through support to the development of economic laws, and strengthening asset management companies. It has focused on improving the legal and regulatory framework through capacity building for capital markets development and supporting enhancement of the Securities Law. It has assisted in the promotion of small and medium enterprises, by developing financing policies and mechanisms, assisting to build credit systems and improving accountability through TAs that improve banking supervision and strengthening banking management, the

Government's auditing system and accounting profession. In complementing PRC's anti-corruption efforts, TAs have been provided to the 1999 Tendering and Bidding Law and the formulation of the 2002 Procurement Law. Many of these interventions have improved the administrative environment for international investors, and promoted domestic investor confidence. The Government at both national and local levels has engaged in policy dialogue on the Governance aspects of infrastructure projects (energy, environment, transportation projects, water supply etc) and more directly through TAs supporting tariff reforms (e.g. urban heating) and welcomed the policy advice provided by ADB through studies, seminars and conferences. More recently ADB has supported the concept and practice of public consultation through its infrastructure projects, and has consulted systematically on an on-going basis with NGOs on a number of issues.

### **ADB's Operational Strategy For Good Governance in PRC**

Good governance will be a key theme throughout ADB's strategy for the PRC. As such, it will be integrated throughout ADB's overall approach, as well as effected through directly focused technical assistance work. Selection of governance -specific TAs will be selected on the basis of their strategic influence and ability to result in significant impacts.

In addressing pro-poor economic growth to reduce poverty, the ADB will strengthen and enhance administrative, financial, legal and regulatory systems needed in a market economy. ADB will contribute to improve public accountability and PRC's anti-corruption efforts. It will continue to help PRC build its 'enabling administrative setting' for private enterprise development, particularly Small Medium Enterprises. Support will be provided to enhance public service delivery through developing capacity of utilities, improving local governance to more effectively administer services to the public. It will encourage the use of NGOs in service delivery and access to information for such services.

In line with development in the Central and Western Provinces, ADB will support public administration capacity, service delivery and improved distribution of benefits to these regions. Where feasible, in provincial locations selected for concentration, ADB will carry out governance work to help reduce the divide between the coastal and interior regions. At the national level it will seek ways of supporting improved and more balanced fiscal regimes for poorer provinces and clarifying regulations and jurisdictions which effect local service delivery at provincial levels.

In line with PRC's strategic thrust of building a sound basis for international transactions and enhancing private sector development, ADB will continue its support to regulatory and legal frameworks, and undertake activities that encourage SME development. Such help will also indirectly support private sector investment in the Western Regions by building investor confidence in a more solid rules-based business environment.

In relation to infusing sound development management components in all of its work, greater attention will be paid in all projects to incorporating governance components. In infrastructure projects, governance components will be stronger and move beyond simple policy dialogue. Components will be incorporated more fully, with such elements as privatization, cost-recovery, market-based and tariffs, fees for service, departmental reorganization, accounting and auditing improvements and legal frameworks. Within sector work, governance elements will be incorporated which address reorganization of sector administration, citizen consultation, responsiveness to consumers and extending benefits to disadvantaged.

## **PRC's Strategy For Good Governance**

The government's strategy is composed of several parts. First, the government identified economic development as the country's overriding priority in 1978. Reform of the economy came first, while other reforms such as of the legal and administrative system followed. Second the pace of reform has been gradual with an emphasis on social stability. When reforms appeared to become de-stabilizing, they have been reigned in or curtailed. Third, reform has been accompanied by some stringent controls on population growth (the one child policy) and on population movement (through the household registration system). The government appears to have relaxed controls in both areas somewhat. Recently the government has abolished the household registration system in an effort to facilitate labor mobility and reduce unemployment. Fourth, the government pilot tests reforms first before they are generalized to the country. The government also permits local government to adapt policies to suit local conditions. Local governments thus have considerable discretion in the implementation of policy. Fifth, reform has been accompanied by a comprehensive review of the role and functions of government. In the process of restructuring in the 1990s each government agency has been asked to justify its existence. Finally, government has kept spending to prudent levels. Although the government has run deficits, these have been well within appropriate limits for sustainable economic growth.

Watershed years in the development of the strategy were 1978 when economic growth became the country's first priority and 1992 when the CCP adopted the market economy to replace central planning. After economic reform came reform of the legal system. This involved a political commitment at the highest levels to a system of rule by law (to replace the chaos and lawlessness of the Cultural Revolution period). In 1982 authorities promulgated a new Constitution that emphasized the importance of law. Authorities then produced organic laws for local government and for most major government institutions. The government has invested tremendous resources in the development of economic and civil law. The emergence of administrative law has lagged behind, however.

Since 1992 the strategy has recognized the importance of using primarily macro-management levers to control the economy including interest rates, exchange rates, and money supply. The government has vested control of these levers in new institutions, including the People's Bank of China, which became the country's central bank. Reform of public finance has followed to increase tax revenues especially for the central government, reform the budget system, and reform the system to control public expenditure.

Since 1980, the strategy has also sought to improve the capacity of the bureaucracy through civil service reform including the implementation of merit selection systems and appropriate levels of compensation.

Other reforms have followed, such as the struggle against corruption, moves to diversify the delivery of public services, promotion of the private sector and corporate governance, and partnering with civil society to provide social services. To a certain extent government has been reactive in these areas – designing new policies in response to public pressure for reform and threats to stability.

## **How ADB Assists to Enhance Governance**

In spite of the impressive progresses in enhancing governance in the past two decades in PRC, an ADB study indicates that the following issues continue to deserve attention.

- **Public finance management**

**Tax system reform:** Although central government revenue as a percentage of GDP has improved since 1996 when it fell to a low of 10.7 percent, tax policy and tax administration lag behind changes in the economy. In spite of significant improvements problems remain including revenue adequacy, the distortionary nature of the tax system (especially VAT), and the need to significantly strengthen the tax collection system.

**Budget reform:** Budget reform is underway but more needs to be done. The most significant weakness in the budget formulation process is a lack of comprehensiveness (extra-budgetary funds continue to be a large part of government spending). Revenue forecasting is underdeveloped and multi-year expenditure frameworks are not used. The role of the people's congresses in budget approval is also weak. Establishing a Treasury Single Account at the People's Bank of China, to be managed by the Ministry of Finance, should strengthen treasury management.

**Decentralization and central-local fiscal relations:** In practice local budgetary autonomy is severely limited by many spending mandates from the central government, local governments' lack of taxing powers, their high dependency on central transfers, and their weak local tax base. Although there is an elaborate system of intergovernmental transfers, the overall effect of the transfer system is disequalizing. The administrative division of labor between central and local governments often lacks clarity and transparency. Moreover many local governments lack the capacity to manage responsibilities delegated to them by the central government. Because of the weak fiscal position of many poor counties, the delivery of basic public services such as health care and education is deteriorating and salaries of civil servants are delayed. The user fees imposed for health and education are very regressive for the poor.

- **Public administration reform**

**Civil service reform:** Since March 1998 significant steps have been taken to downsize the civil service. At the central and provincial level half of all civil servants were laid off. Similar cuts are now being carried out at subprovincial levels throughout the government system. Still, the size of the public sector continues to be very large. In spite of considerable progress towards self-sufficiency and corporatization, the state continues to support vast numbers of employees of service units/institutions (shiye danwei). Civil servants are relatively poorly paid by comparison to managers in the private sectors, which lowers their motivation.

**Policy co-ordination capacity reform:** The administrative system remains highly compartmentalized. Although coordinating mechanisms exist (such as leading groups) many issues can only be resolved at the top. The lack of coordination and information sharing hampers efficiency and increases policy inconsistencies. The government has strengthened the supervisory role of the NPC. Still more should be done to reduce overlapping responsibilities and increase co-ordination between government departments and higher-level policy making committees.

Anti-corruption reform: Considerable efforts have been made to reduce corruption opportunities by improving the legal and regulatory systems. The government has also made increasing efforts to find and punish people, including senior officials, engaged in corrupt practices. Political leaders have led a fierce campaign against corruption. Still, corruption continues to be a serious problem that undermines people's confidence in government. Corruption is an issue that needs sustained attention and incorporation of ideas from international experience

- **Legal system reform**

Legal reform: Many years of legal reform have seen substantial increases in the amount of law and regulation and in the growth of the legal profession. With the country's switch to a market economy, the legal basis of administration of the economy had to be completely re-written. Still the legal system continues to suffer from inconsistencies in the law, arbitrary enforcement, a weakly institutionalized citizen complaints system, and a shortage of trained lawyers. Continued emphasis should also be given to the training of lawyers and judges. PRC's accession to the WTO will require thorough reviews of all economic laws, many of which are now underway.

Judicial reform: Although reform of the judiciary has improved the quality of staff, capacities remain relatively weak and judges are poorly paid. Because of the dependence of local courts on local governments, localism in judicial decisions is a severe problem that undermines the impartiality of the judicial system. The state still does not behave like any other actor before the courts, a necessary condition for a system of rule of law.

Regulatory reform: PRC's transition to a market economy requires the development of an entirely new regulatory system. Despite the significant progress that has been made, there are still problems of clarity, consistency, arbitrariness and lack of transparency within the regulatory regime. In part this stems from the lack of a well functioning system for resolving ambiguities and inconsistencies once they become apparent in practice and because agencies often issue regulations to empower themselves rather than to provide reliable guidance to affected parties. Dependency on local governments and/or on the collection of fines for funding has affected the capacity of regulatory agencies to carry out their duties. Although redress mechanisms exist, their scope is limited. Although not usually required, public hearings on regulations are increasingly common. Implementation of regulations has been undermined in some cases by corruption and noncompliance.

Legal aid reform: Government has established a rudimentary legal aid system with a network of legal aid centers. The system remains understaffed and under funded however, impacting its capacity. Strengthening the legal aid system is essential to ensure that the poor have equal access to the protection of the law.

- **Public service delivery**

Alternative public service delivery systems: To increase the efficiency of public service delivery systems governments should be encouraged to co-produce services with non-government agencies and organizations. Local governments are already experimenting with a variety of alternative systems, including contracting out, privatization, vouchers, and so forth. However, much more could be done in this area. Replication of successful experiments would help to spread reform.

Role of NGOs: Non-government organizations are beginning to play an increasingly important role in the delivery of public services (e.g., in areas such as the environment; rural development; poverty reduction; health; education; and women's issues). However, many NGOs lack the capacity to undertake this role. Strengthening the capacity of PRC's NGOs would permit the government to cut costs and increase efficiency.

- **Public accountability**

Performance measurement reform: Although some cities now use performance contracting and issue performance pledges, the system is not integrated with policy making and evaluation, nor is it effectively linked with civil service personnel decisions. A comprehensive approach to performance measurement and evaluation is needed.

Auditing and accounting reform: Significant steps to reform the country's auditing and accounting system have already been taken. PRC uses both cash-based and a variant of accrual accounting. Further reform is needed to bring the accounting and auditing system up to the level of international practice. Moreover, PRC faces serious shortage of trained accountants and auditors and should further develop self-regulation professional bodies for accountants and auditors. This issue is linked to the need for further corporate governance reform especially in state-owned enterprises and increased disclosure and transparency.

Statistical system reform: Investment, product, pricing and marketing decisions depend on accurate statistical information. Government and other organizations should provide accurate, high quality, useful and timely statistics to assist economic decision makers. Further reform of the government's system of collecting and disseminating statistics is required.

- **Public-private interface**

Development of small and medium-sized enterprises (SMEs) PRC's increasing reliance on the private sector as the engine of job creation and economic development means that serious restrictions on the further development of the private sector, including SMEs, which are mostly private enterprises, is essential. Among the most serious problems facing the private sector are a lack of access to credit, a lack of transparency in the legal and regulatory framework, and corruption and rent seeking by government officials. A positive environment for private entrepreneurs should be created. This includes reform of the legal system to protect the rights of the private sector, policy reform to reduce arbitrariness, and market reform to improve access and order. Private entrepreneurs should be more active participants in public policy making.

Corporate governance: PRC's accession to the WTO will put more pressure on economic enterprises (including state-owned enterprises) to adopt modern principles of corporate governance including increased transparency and accountability (through supervisory boards of directors) and disclosure of audited financial statements. Use of accounting systems that accord with international practice should also be encouraged. Remuneration packages for managers should be introduced that provide incentives for better performance and that more tightly link their remuneration to enterprise performance.

- **The role of civil society**

Participation in policy making: Appropriate and effective policy is more likely if stakeholders participate in formulating the policy. The government has made great strides in increasing consultation with stakeholders as it deliberates on new policy initiatives (e.g., the 10th Five Year Plan) and laws and regulations. The Marriage Law, the Securities Law, the Procurement Law, and the Bidding Law were all amended after consultation with stakeholders. Still the system of consultation remains largely uninstitutionalized and the scope of participation is rather narrow. Further reform to widen the scope for public participation, make public hearings mandatory, and to institutionalize the system of participation is required.

Role of NGOs: The government has increasingly turned to NGOs in its efforts to diversify public service delivery systems and in its poverty alleviation activities. Strengthening the capacity of NGOs to participate in the policy making system and to extend their reach in society is needed to reduce the burden on government and increase efficiency of service delivery.

Access to information: Although the government regulates the media and the Internet both have played an increasingly important role in the implementation of policy. In recent years state-society relations have been improved through the increased transparency permitted by the internet and the media. Further reform of PRC's system of access to information is urgently needed, however, to increase efficiency, transparency and accountability.

### **Who Benefits from ADB Governance Projects?**

Governance and the means of improving it, namely capacity building are central to the ADB's achieving its strategic objectives. Governance has substantial direct and indirect linkages to poverty reduction. Numerous studies have demonstrated that good governance practices are critical for the main functions of government, which are policy development and monitoring of policy implementation, delivery of services to the population and ensuring an effective enabling environment for private sector development. Key aspects of the administration of government, which, if they don't work well become major contributors to poor performance in all of these functions, leading to increases rather than decreases in the levels and incidence of poverty. Research also demonstrates that there are direct causal links between governance and a country's overall development performance.

### **What Governance Projects has ADB supported in the PRC?**

Item	TA No.	TA Name	Amount (\$)	Approval Date
1	1483	Audit Administration of the People's Republic of China	600,000	21-Feb-91
2	1518	Formulation of Economic Reform Policies and Infrastructure Planning	920,000	28-May-91
3	1675	Assessment of Industrial Sector Reforms	100,000	9-Mar-92
4	1784	Tertiary Sector Economic Reform Policies and Redevelopment Planning	600,000	17-Nov-92
5	1884	Fertilizer Sector Legal and Regulatory Development	183,000	12-May-93
6	1924	Public Enterprise Reform Study	600,000	3-Aug-93
7	1922	Support for Power Sector Tariff and Financing Reforms	450,000	3-Aug-93
8	2118	A Study of Subprovincial Fiscal Relations	500,000	28-Jun-94

Item	TA No.	TA Name	Amount (\$)	Approval Date
9	2120	Corporate Ownership and Management Systems for Yunnan Yun-Jing	400,000	30-Jun-94
10	2186	Strengthening the Legal Framework for Customs Administration	585,000	18-Oct-94
11	2231	Loan Administration and Subproject Accounting Systems Support	100,000	9-Dec-94
12	2257	Enterprise Accounting System Reform	467,000	21-Dec-94
13	2271	State Enterprise Insolvency Reform	590,000	27-Dec-94
14	2383	Fiscal Policy and Regulatory Framework for Social Security System	540,000	23-Aug-95
15	2395	Strengthening of Corporate Management and Marketing and Trading	455,400	7-Sep-95
16	2670	Strengthening Enterprise Reform in Anhui Province	600,000	25-Oct-96
17	2845	Establishment of National Procurement Regulations for the Public Sector	565,000	20-Aug-97
18	2924	A Study of Municipal Public Finance	600,000	27-Nov-97
19	2939	Reform of the Rural Credit Cooperative System	997,000	15-Dec-97
20	3000	Strengthening of the Legal Information System	630,000	23-Mar-98
21	3032	Legislation Drafting Support for PRC Securities Law	150,000	24-Jun-98
22	3101	Capacity Building in Loan Administration and Accounting Procedure	40,000	25-Nov-98
23	3105	Institutional Reform of Yunnan Electric Power Group Corporation	785,000	27-Nov-98
24	3148	Pension Reform	2,400,000	28-Dec-98
25	3253	Strengthening Public Infrastructure Investment Policy	600,000	8-Sep-99
26	3279	Development of Economic Laws	1,400,000	19-Oct-99
27	3457	Implementation of the Tendering and Bidding Law and Related Regulations	565,000	14-Jun-00
28	3631	Formulation of the Government Procurement Law	578,000	20-Feb-01
29	3672	WTO Membership and Foreign Trade Law Reform	700,000	14-Jun-01
30	3673	Pro-Poor Urban Heating Tariff Reforms	850,000	19-Jun-01
31	3890	Banking Laws and Regulations	800,000	25-Jun-02
32	3931	Establishing the National Electricity Regulatory Commission	500,000	24-Sep-02
33	3971	Enforcement of WTO Rules by Judicial System	400,000	4-Nov-02
34	3979	Fiscal Management Reforms	875,000	8-Nov-02
35	3980	Strengthening Public Debt Management	400,000	8-Nov-02
36	4095	Policy Reform Support	150,000	11-Apr-03
37	4117	Power Pricing Strategy: Tariff Setting and Regulation	500,000	21-May-03
38	4201	Policy and Institutional Support for the Social Insurance Administration	700,000	21-Oct-03
39	4205	Advisory Support for the National Council for Social Security Fund	500,000	27-Oct-03
40	4237	Support to the Review and Planning for the Development of the Legal and Judicial System	350,000	04-Dec-03
41	4298	Capacity Strengthening of PRC's NDP Process	360,000	19-Dec-03
<b>Total</b>			<b>24,085,400</b>	

## What are ADB's Plans for Future Governance Investment?

	Proposed TA	Proposed Amount (\$)
<b>2004</b>		
1	Enhancing Effectiveness of Environmental Investments	500,000
2	Strengthening Enabling Environ. And Building Institutional Capacity to Combat Land Degradation	1,000,000
3	Statistics System Strengthening for China Banking Regulatory Commission (CBRC)	400,000
4	SME Development and Finance	550,000
5	Agricultural Taxation Reform Support	500,000

	<b>Proposed TA</b>	<b>Proposed Amount (\$)</b>
6	Support For Reforms in Compulsory Education Financing	500,000
7	National Food Safety Strategy and Regulatory Framework	400,000
8	Development of Economic Laws II	400,000
9	Support for Environment Legislation	600,000
<b>2005</b>		
1	Strengthening the Key Project Inspectorate II	400,000
2	Study on Public Financial Emergencies and Ways to Justify Capital Management in Poverty-Stricken Areas	200,000
3	Policy Support for State Asset Management and Supervision Commission (SAMSC)	150,000
4	Environment Management in Western Region	500,000
5	Internal Crediting and Ranking Framework for Small and Medium Domestic Commercial Banks	500,000
6	Rural Pension System Reform	500,000
7	Resolution of NPLs and Development of ABS	500,000
8	Urban Sector Project Preparation I	500,000
9	Urban Sector Project Preparation II	500,000
10	Capacity Building in Judicial System on Financial and Economic Laws	500,000
<b>2006</b>		
1	Power Sector Restructuring III	600,000
2	SME Development and Finance II	500,000
3	Bond Market Development	1,000,000
4	Strengthening Commercial Bank's External Audit	600,000
5	Rural Health Sector	500,000
6	Study and Application of PRC Crisis Management System	600,000
	<b>Total</b>	<b>12,900,000</b>