

## I. INTRODUCTION

The fundamental development management challenge facing the Government of the People's Republic of China (PRC) is to reform the state structure so that it is appropriate for a market economy, while at the same time maintaining both economic growth and social stability. Only through economic growth can the PRC substantially reduce poverty. The State and society will both play key roles in achieving this goal.

The role of the State is to organize efficient and effective markets, remedy market failures, and develop human resources, all of which are critical for sustained development. In transition economies such as the PRC, the State is obligated to mitigate the hardships caused by the transition (UNDP 2001a). Reinventing the State to fulfill these roles effectively is critically important.

Economic growth also depends on society's efforts, and therefore requires that the State create an enabling environment for development that encourages the participation of nonstate organizations, including quasi-government, nongovernment, nonprofit, and community-based organizations; and the private sector. Economic growth depends on a partnership between the State and society.

The Asian Development Bank (ADB) in its 1995 Policy entitled "Governance: Sound Development Management" defines governance as "the manner in which power is exercised in the management of a country's social and economic resources for development." This is a particular approach to managing the State and state-society relationships that enables the State to carry out its roles effectively. The approach calls for (i) all organizations and individuals to be accountable; (ii) public participation; (iii) transparent policies, rules, regulations, and laws and processes for implementing them; and (iv) predictability and continuity of development policies, rules, regulations, and laws that govern the development process. Such an approach helps secure the effective markets that are necessary for economic growth and also enables nonstate actors to contribute to the development process.

Poverty reduction, a principal goal of the PRC and the principal goal of ADB, depends on effective markets and the environment for growth with significant redistribution of the beneficial effects, which are characterized by a level playing field. Effective markets can channel investment to help the poor, and pro-poor growth and poverty interventions (ADB 2001b). These are necessary preconditions for long-term, sustainable poverty reduction.

Effective markets are determined by economic and noneconomic factors. The goal of this report is to assess key factors that impinge on markets and thereby inhibit growth. It first examines the structure of the Government and then discusses such key issues as public expenditure management; core government functions (public administration, the legal system, public service delivery, and accountability); the interface between the public and private sectors, especially the creation of an enabling environment for the development of the private sector and corporate governance issues; and the development of civil society, including enhancing the capacities of nongovernment organizations (NGOs) to assist with development and with access to information.

## A. Twenty Years of Reform: The PRC's Transition Economy

During the past 2 decades the PRC has made economic development a top priority. Beginning in 1978 the authorities opened the country for foreign investment (“the open door policy”) and adopted a strategy of export-led growth. The institutions of the PRC's centrally planned economy have been gradually replaced by mechanisms that are more appropriate for a market economy. The Government de-collectivized agriculture, put in place a system of household contracting, and gave the state-owned enterprises (SOEs) more autonomy. The authorities also decontrolled prices and decentralized and liberalized the right to engage in foreign trade. In 1992 the Communist Party of China (CPC) formally adopted the policy of replacing central planning with a market economy. One of the strengths of the PRC's transition from a centrally planned to a market economy is the gradualist approach taken. Old systems of development management were not dismantled until new systems were developed and tested. While this process takes considerable time, it reduces the cost of mistakes by testing new approaches at the local level before adopting new development management systems on a national basis.

As a result of these and other policies, economic growth has been nothing short of spectacular. From 1986 to 1990 gross domestic product (GDP) grew by an average annual rate of 7.9%, rising to an average of more than 10% per year from 1991 to 1999 (National Bureau of Statistics 2000a, p. 23). GDP growth reached a high of 14.2% in 1992, and even though it has declined somewhat since then, it achieved a respectable 7.1% in 1998–1999 and was between 7% and 8% in 2000 and 2001.

From 1985 to 1999 average annual per capita incomes of urban and rural workers increased from 748 yuan(CNY) to CNY5,888 and from CNY547 to CNY2,987, respectively.<sup>1</sup> As incomes have risen, so has the structure of the economy changed. Primary production, which contributed 30% of GDP in 1980, now only accounts for 17.7%. Secondary production, including industry and commerce, has remained stable at about 48–49% of GDP. The tertiary sector, however, has increased substantially from 21% to 33% of GDP. These changes are reflected in employment patterns. From 1980 to 1999 the percentage of the workforce employed in the primary sector fell from nearly 70% to 50%, while the number employed in the tertiary sector increased from 13% to 27%. The ownership structure of the economy is also changing. In 1978 virtually all-industrial production was in state or collective hands, but by 1999 SOEs accounted for only 28% of the value of gross industrial output. By the late 1990s the domestic private sector accounted for at least 13% of GDP or, using a broader concept of the private sector, up to 50% of GDP (ADB 2001a, p. 70).

The success of the PRC's development strategy is reflected in the country's relative position in the United Nations Development Programme (UNDP)'s human development ranking (Table 1). The PRC's human development index value was 0.718 compared with 0.564 for South Asia and 0.467 for Sub-Saharan Africa in 2001.

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<sup>1</sup> In 2001 CNY1 = \$0.121.

**Table 1: Human Development Rankings  
Selected Asian Countries, 2001**

Country	Ranking
Japan	9
Republic of Korea	27
Malaysia	56
Thailand	66
Philippines	70
<b>People's Republic of China</b>	<b>87</b>
Viet Nam	101
Indonesia	102
India	115
Cambodia	121
Lao People's Democratic Republic	131

Note: Rankings range from 1 to 162, with 1 being the highest.

Source: UNDP (2001b).

The structural changes have been accompanied by increasing unemployment, dislocation, and a growing migrant workforce. Although unemployment is officially only 3.1% in the PRC's cities, analysts estimate the rate to be 7–8% of the urban workforce if laid-off workers are included. By 2000 the number of urban unemployed had reached an estimated 20 million people. Total layoffs were estimated at some 23–25 million people, increasing at a rate of 4–5 million per year (UNDP 2001a, p. 70). An average 12–13 million new workers will enter the labor market annually. There are also currently about 150 million surplus rural laborers, many of whom wish to move to cities for jobs and a better quality of life. This number swells and contracts at times when crops are not being planted or harvested. Even with increasing emphasis on improving opportunities in the central and western provinces, rural enterprises are unlikely to absorb more than a fraction of the rural workers who will need jobs outside the agriculture sector. This reinforces the fact that development of the rural economy is increasingly dependent on conditions and policies affecting the economy as a whole (OECD).

Economic growth has been accompanied by increasing income disparities. In 2001 the Gini coefficient (a measure of inequality where 0 represents perfect equality) stood at 0.43 for the PRC, up from 0.28 in 1982—a growing disparity mostly accounted for by the gap between urban and rural incomes (see South China Morning Post, Hong Kong, China, 8 October 2001; UNDP 2001b). Countries with a Gini coefficient of 0.50 or higher are mainly concentrated in Africa and Latin America and among the poorest in the world. The PRC ranked 24<sup>th</sup> out of 90 countries on the UNDP's human poverty index (where 1 was the least poverty-stricken), with an estimated 18.5% of the population, or about 250 million people, surviving on \$1 per day or less, the international standard poverty norm (UNDP 2001b, p. 149).<sup>2</sup> These figures indicate the scale of the problem. The poorest parts of the country were located in the landlocked central and western areas, including the 12 provinces of Chongqing, Gansu, Guangxi, Guizhou, Inner

<sup>2</sup> The official poverty line in the PRC using CNY650/day places about 30 million people, in poverty. As a result of rapid economic growth and the Government's anti-poverty program, absolute poverty in rural areas fell from 80 million in 1995 to 30 million by the end of 2000. The Central Government alone spent about CNY25 billion (\$2.9 billion) on its direct poverty reduction program in 2000, about 29 times more than in 1980.

Mongolia, Ningxia, Qinghai, Shaanxi, Sichuan, Tibet, Yunnan, and Xinjiang, which together accounted for more than 27% of the total population.

Meeting the PRC's next challenge, the impacts of its accession to the World Trade Organization (WTO), will further transform the economy. Many sectors will have to undergo significant adjustments as the country's economy is opened to cheaper imports. The Government must encourage the restructuring of these sectors either to lower costs or to focus on higher-value products. Agriculture is one sector that will be particularly affected by WTO membership, but many others will also be. For example, the financial and insurance systems must be strengthened to compete with foreign banks, insurance companies, brokerages, and other financial institutions, and the legal and regulatory systems must be made more transparent and less arbitrary.

Pressure for reform has come both from within the PRC and from outside. Political pressure grew in the wake of the Cultural Revolution (1966–1976), when economic development was neglected and the economy stagnated. To regain the initiative and rebuild relationships with the people, in 1978 the CPC refocused the country's priorities toward economic development. Administrative and legal reforms became necessary as the economy developed, particularly after 1992, when the CPC adopted a market economy as the appropriate system for the country. Domestically, people are expecting better lives and higher incomes. Policies must be put in place so that certain groups are not excluded from the benefits of economic growth and to ensure that the social costs of the transition from a centrally planned to a market economy remain within tolerable limits. External pressure followed the decision to invite foreign investment into the country and to adopt an export-led development strategy in the 1980s. Pressures for change were generated by the PRC's increasing integration into the global economy, and its accession to the WTO has put additional pressures on the economic, administrative, and legal systems.

During the past 2 decades the PRC has confronted these challenges head on and made substantial progress. The economy has grown steadily throughout the reform era, and the country has also tackled the problems of reforming the SOE system by granting enterprises more autonomy, restructuring them, and reforming their ownership systems. Accountability has been increased through a variety of mechanisms, including the "cadre" responsibility system, the 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 various channels. Reform of the legal system and the judiciary has increased predictability. The PRC's emerging civil society is now a more active, if junior, partner in the delivery of many public services.

Further reform is needed, however, to ensure that the country's development management system serves economic and social development. Just a few areas of the many that require attention include public financial management; public administration; and the legal, judicial, and regulatory systems.

## **B. The Concept of Sound Development Management**

ADB's experience in Asia and the Pacific indicates that sustainable development depends not only on the quality of decisions made in relation to development and reform, but also on how these decisions are taken and carried out. In 1995 ADB members reached consensus to apply this fundamental lesson more systematically to ADB's overall operations (ADB 1995). This policy stresses the importance of sound development management, the core

elements of which are accountability, participation, predictability, transparency, and efficiency and effectiveness. Sound development management is one of the three pillars of ADB's Poverty Reduction Strategy. Without sound development management, efforts at reducing poverty will be ineffective. Poverty reduction requires economic growth and effective markets, which in turn depend on a basic foundation of capable institutions and sound practices.

The Government of the PRC fully subscribes to the principles of sound development management. Evidence of the PRC's commitment is found in the 10<sup>th</sup> Five-Year Plan (2001–2005), formally approved by the National People's Congress (NPC) in March 2001, and in other documents. For example, the plan, the Constitution of the PRC (1982, amended), and various organic laws emphasize the importance of accountability. The plan explicitly endorses measures to encourage clean government and to eliminate corruption (Chapter XXIII). In the plan, the Government endorses steps to increase participation, for instance, by reducing the barriers to labor mobility by reforming the household registration system (Chapter XI); providing a level playing field for all enterprises regardless of their ownership structure (Chapter XVI); holding public hearings on policy proposals (Chapter XVI); and encouraging community management systems and a greater role for NGOs (Chapters XVIII and XIX). The plan explicitly calls for the further development of democratic elections, policy making, management and supervision, and improvements to village self-government, along with community democracy and democratic management systems in enterprises (Chapter XXII). Improving predictability is also on the Government's agenda. The plan calls for further reform of the legal system to promote the rule of law and increased efforts to reform the judiciary and judicial systems (Chapter XXIII). Holding public hearings, requiring that public works projects be tendered (Chapter XVI), and mandating that more information on foreign investment flow be made public (Chapter XVII) are all actions designed to increase transparency. Finally, the Government encourages improved service quality and will adopt different modes, both governmental and nongovernmental, to deliver public services (Chapter V). Monopolies will be replaced by systems that foster fair competition to improve efficiency in providing public goods and services.

This report focuses on factors that impede or facilitate economic development.<sup>3</sup> It seeks, in particular, to identify those factors that may hinder economic development to help the Government craft strategies by better managing them or by minimizing or eliminating their impact. It also seeks to identify possible areas of ADB assistance that can focus directly on improving the PRC's sound development management regime.

## II. BACKGROUND AND OVERVIEW

The PRC's Constitution dates from 1982 and was drafted to replace a Cultural Revolution-era document that did not serve the needs of economic development particularly well. According to the 1982 Constitution, the PRC is a unitary state that centralizes all formal political power in the central Government. While the central Government may delegate power to local governments, the center may alter or rescind such delegation at its discretion. The PRC is divided into 31 provincial-level administrations, including 4 provincial-level cities (Beijing, Chongqing, Shanghai, and Tianjin).<sup>4</sup> The provinces are divided into 331 prefectures (or prefecture-level cities), 2,109 counties (or county-level cities), and 44,741 towns or townships

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<sup>3</sup> The terms of reference for this study precluded an analysis of political factors that might impede or facilitate economic development.

<sup>4</sup> This number does not include Taipei, China; Hong Kong, China; or Macau, China.