

improving, the CPC still plays an important role in controlling what people may read and hear. The Internet is challenging the dominance of the State in the area.

IV. CONCLUSIONS AND IMPLICATIONS

Sound development management is essential for economic and social growth. Only with sound development management can the economy grow, and this is a precondition for achieving other critical goals, such as poverty reduction. The PRC has made genuine progress in improving accountability, participation, and the predictability and transparency of operations in a substantial number of key areas, including public financial management; public administration; legal, judicial, and regulatory systems; public service delivery; public accountability; the public-private interface; and emerging civil society.

A. Recommendations for the Government

To further improve development management and remove remaining largely noneconomic factors that hinder efficient and sustainable economic growth, the Government may consider further reforms in some of the following areas.

1. Public Financial Management

Reform of public financial management will continue to be critical for improving the system's capacity to develop further. Specific areas of reform include the following.

- (i) Strengthen the revenue generation mechanism, especially the tax collection system, through increased computerization and further reform of the judiciary to strengthen tax enforcement.
- (ii) Evaluate the possibilities of moving toward a consumption-type of VAT. The distortionary nature of the tax system, which relies heavily on an origin-based, production-type of VAT, hampers export competitiveness, penalizes investment, and generates distortions through cascading. The Government should consider replacing the production-type of VAT with another kind of tax.
- (iii) Review enterprise income tax preferences regularly to determine whether they are still needed. The system of tax preferences has been a major drain on government revenues. In many cases the preferences may not be needed to attract investment.
- (iv) Ensure that budgeting is comprehensive and merge off-budget items with the budget to produce a single, consolidated, comprehensive budget that includes capital and all recurrent expenditures. The most important problem of the budgeting system is that it lacks comprehensiveness. Local governments have created off-budget items to help them manage necessary spending that is often mandated by the central Government. Because the budget is not comprehensive, however, the Government is unable to use the budget as a management tool.
- (v) Further develop revenue forecasting by relying more heavily on research organizations that have modeling expertise. More accurate revenue forecasts will permit better planning. While the Government does engage in revenue

forecasting, the quality of forecasts could be improved. One way to do this would be to rely, in part, on additional sources of information for forecasts.

- (vi) Strengthen the NPC's role in budget approval and supervision and mandate that MOF consults the NPC on in-year adjustments to the budget. Currently the NPC plays a relatively minor role in approving the budget and supervising its implementation. Strengthening the NPC's role would ensure that all players understood the reasons for the priorities set by the Government, which would smooth implementation.
- (vii) Consider further reform of the system of intergovernmental transfers to ensure that they attack the problem of growing regional income disparities. The system of intergovernmental transfers has not prevented poor areas of the PRC from becoming poorer, and the gap between rich and poor areas seems to be widening. The effectiveness of the intergovernmental transfer system should be investigated with a view to reducing regional income disparities and ensuring that the poor have access to such key services as health and education.

2. Public Administration

The Government has carried out many restructuring campaigns, the most successful of which have been those that sought to change the role of the State to suit a market economy. Attempts to downsize the State have been less successful, and bureaucratic overlaps and unclear lines of authority persist. Because of the importance of financial incentives the Government should consider strengthening MOF's role in restructuring policy making and implementation. MOF and local finance bureaus could play a gatekeeper role, evaluating bids for more resources that take agency spending above certain ceilings. Specific recommendations include the following:

- (i) Strengthen MOF's role in government restructuring to ensure financial discipline and to eliminate bureaucratic overlaps and unclear lines of authority.
- (ii) Eliminate abuses of the civil service, such as buying and selling positions, through more transparency, effective law enforcement, and supervision. Although civil service reform has resulted in a meritocratic selection system, abuses of the system are still quite common, especially at the local government level. A new system to deal with abuses could build on the experience of some provinces in making the selection system more transparent.
- (iii) Rotate more high-quality officials to the disadvantaged west to increase the western provinces' policy and administrative capacities. Such officials might be required to spend time in the west before being considered for promotion. The western region has been disadvantaged in many respects, including in the provision of high-quality human resources. Although there is a rotation system for civil servants, it should be expanded and incentives to encourage high-quality officials from other areas to participate should be increased.
- (iv) Undertake further reform of the civil service compensation to bring government compensation packages in-line with those in the enterprise sector. Policies to monetize all benefits should be accelerated to control costs. The Government should continue to carry out surveys of pay trends in the nongovernment sector

and implement effective systems to link pay to performance. Even though the Government increased civil service salaries steadily in the late 1990s and twice in 2001, they continue to lag behind compensation levels in the private sector. This demoralizes civil servants and attracts corruption.

- (v) Continue the strong campaign against all forms of corruption, including through stronger enforcement of the law and reform of the police, the procurate and the judiciary. The Government's campaign against corruption, which has included arresting and trying senior officials, has been effective. Nevertheless, much more needs to be done to ensure that corrupt practices are wiped out. A weak link in the drive against corruption is the quality of the police and the judiciary. Moves to improve their education levels and remuneration packages should be encouraged.
- (vi) Institutionalize the system of popular participation in policy making by requiring public hearings, opening legislative hearings, soliciting opinions, setting up advisory bodies, and consulting community groups (including NGOs). Government officials have begun to consult not only stakeholders inside the bureaucracy, but also the general public, before making policy. This is a new and welcome development. As a result public hearings, legislative hearings, and opportunities for NGOs to influence the policy process have increased in recent years. These trends should be institutionalized.
- (vii) Promulgate a government information transparency law to clearly define the scope of transparency in government and encourage the Government to become more transparent. To facilitate participation in the policy process, citizens must be well informed about Government policy and the problems facing the community. To this end, a more transparent government is required. Moves to increase transparency at the town and township level should be spread to urban areas and codified in a law that defines the scope of transparency in Government.
- (viii) Attempt to change the administrative culture to more highly value popular participation in policy making by evaluating officials on the extent to which they have consulted the public before they make decisions that affect the public.

3. Legal, Judicial, and Regulatory Systems

Suggested reforms include the following:

- (i) Reduce inconsistencies in the law through more expert law drafting and wider participation in the review of draft laws. While the PRC has progressed much in its capacity to draft laws, including the establishment of expert law drafting bodies within the State Council and the NPC, further capacity building in this area is required. Wider participation in the review of draft laws would reduce inconsistencies and improve predictability.
- (ii) Reduce arbitrary enforcement of the law through stricter quality control in selecting police and procuratorial and judicial personnel, and enhance their training and supervision. Uniform enforcement of the law continues to be problematic in many parts of the PRC. Tighter quality control and supervision of

law enforcement agencies and increased training should reduce arbitrary enforcement. Examining the incentives for reliable and predictable law enforcement is also required.

- (iii) Reduce judicial localism by removing local authorities from decision making about judicial personnel and ensuring the financial independence of local courts. Judicial localism is a particularly serious problem that could be better managed by reducing local courts dependence on local governments.
- (iv) Address the shortage of trained lawyers and judges by expanding legal education and training opportunities and increase the professionalism of lawyers by strengthening the role of professional bodies.
- (v) Establish an effective system for resolving jurisdictional disputes among competing regulatory agencies. The regulatory system has developed rapidly, with many agencies making rules that conflict with rules made by other agencies. A more effective system for resolving jurisdictional disputes among competing agencies is required.
- (vi) Institutionalize a system of requiring regulators to consult with regulated entities in drafting new or revising old regulations.
- (vii) Fund regulatory bodies independently of local governments and ensure their financial autonomy by funding them directly from the central Government. This will enhance the independence of regulatory bodies, especially at the local government level.
- (viii) In line with the recommendation that the Government consider drafting a government information transparency law, it may also consider a more effective system for periodic review of the extent to which previously secret regulations may be made public. These steps are needed to ensure that regulated parties understand what is required of them and that regulations actually achieve their purpose.
- (ix) Draft laws or sets of procedures to govern the operations of government bodies in making and applying rules. Government agencies should be bound by specific procedures to ensure uniformity and predictability.
- (x) Further develop the system of legal aid so that it better serves the poor, including popularizing it in rural areas and in the west. Although many steps have been taken to improve the legal system, they may be ineffective if ordinary people do not have access to it. To address this concern the Government has established a system of legal aid; however, the system needs to be expanded to better serve the poor.

4. Public Service Delivery

Although the Government has made substantial improvements in its service orientation, further actions are still needed.

- (i) Improve efficiency in providing public services through more competitive market entry by breaking up monopolies, especially in the area of public utilities, and consider promulgating an antimonopoly law.
- (ii) Improve efficiency and local governments' capacity to manage the new systems effectively, replicate the practices of some advanced cities that use alternative public service delivery systems such as contracting out, internal markets, franchising, vouchers, privatization, and public-private partnerships. Using such mechanisms effectively requires new capacities in the public sector. Governments should be required to ensure that they obtain appropriate service quality levels and value for money through improved reporting, supervisory, and contract management capacities in local government.

5. Public Accountability

The PRC has established effective mechanisms for holding officials accountable and has drafted accounting and auditing laws, rules, and regulations that comply with international practice. Enforcing the standards, however, especially in economic enterprises, has been a continuing problem. The Government should make greater efforts to enforce the standards, perhaps by increasing the intensity of auditing, increasing the professionalism of auditors, and introducing stiff penalties for violators. The Government should continue with reforms in its accounting, auditing, and statistical systems, especially by implementing standards based on international practice in both the public and private sectors.

6. Public-Private Interface

The legal and regulatory system for promoting and protecting the private sector has received government attention. Nevertheless much more needs to be done, including the following:

- (i) Further reform the laws and regulations related to promotion of the private sector, for example, the recently passed Law on the Promotion of SMEs and an antimonopoly law. The Government should also enact laws to protect private property and amend the Constitution in this regard. Research projects need to be undertaken that focus on the appropriate regulatory, legal, and economic policies for a healthy private sector.
- (ii) The Government may consider establishing a high-level policy group to improve the coordination, continuity, and consistency of policies for the private sector. Public policy for economic development should be well coordinated, have continuity, and be consistent and predictable? these are especially important for the development of the private sector.
- (iii) Further improve the environment for the private sector by expanding a credit guarantee system and providing microfinance for SMEs.³⁹ Among the problems facing private enterprises perhaps the most significant is access to credit.

³⁹The PRC's top legislators endorsed the Law on SME Promotion and the Law on Promoting Cleaner Production at the 28th meeting of the NPC's Standing Committee on 29 June 2002.

Because most private businesses are small, many large institutional lenders are unwilling to provide credit, which they see as high risk.

- (iv) Reorient the Government to a new role of being a service provider to public and private entrepreneurs. This requires the Government to provide basic information about international trade, quality standards, and the domestic and overseas market situation; assistance to reform ownership structures; and help for improving management and upgrading technology.
- (v) Provide more support for NGOs that are promoting the private economy, such as the All-China Federation of Chambers of Commerce. NGOs have an important role to play in the market economy. They have information about the operations of the private sector and are keenly aware of the problems. The Government should develop its relationships with NGOs to better inform policy making and implementation.
- (vi) Improve corporate governance by requiring that corporate management groups be selected according to market mechanisms, not appointment by government agencies. Moreover, managers should no longer be assigned administrative ranks and the selection process should be transparent. Improved corporate governance is critical for economic development. Efficient management of the country's enterprises requires substantially improved levels of transparency and accountability. Management decisions should be driven by market forces.
- (vii) Reform the ownership structure of SOEs by reducing state shareholdings, selling government assets, opening access to private investment, and attracting capital investment from nongovernment sources. In addition, the Government should increase the transparency of the ownership structure and ensure the rights of minority shareholders.
- (viii) Strengthen the requirements for transparency of financial statements of public and private corporations and enforce the new standards effectively.
- (ix) Link the remuneration packages of managers of SOEs to their performance (for example, share value or profitability) and increase compensation packages to better reflect their responsibilities. Remuneration packages should also be more transparent. Motivating managers is critically important for the sound development of the economy, especially in the corporate sector, where compensation has traditionally been linked to administrative rank or the scale of an enterprise, not its performance.

7. Civil Society

In recent years the PRC's policies have focused on partnering with civil society to expand the Government's capacity to solve social problems. The roles of the PRC's unique NGOs have increased substantially, providing an increasing array of services. The Government also regulates and supports them. Nevertheless, further improvement could be possible by means of the following:

- (i) Increase the NGOs' capacity to participate in policy making and in drafting laws and regulations through training and the provision of additional resources.

- (ii) Re-examine the policy of restricting NGOs geographically. The Government should consider permitting NGOs to set up branch organizations at lower administrative levels and allowing them to operate in more than one administrative jurisdiction. It should also consider allowing more than one NGO to operate in the same field or scope of operations so that they may compete and the best ones can grow and prosper.
- (iii) Encourage NGOs to follow good corporate governance practices. To this end the Government should not only lay down appropriate rules and regulations, but should help NGOs meet these challenges.
- (iv) Promulgate a law to give legal status to NGOs. Clearly defining the role and legal status of NGOs would remove uncertainties and permit NGOs to develop further.
- (v) Keep the effectiveness and need for restrictions on access to information, including the Internet, under constant review. Access to information is critically important for the development of the economy. Investment, pricing, and market decisions all depend on accurate information delivered promptly. The PRC's media management should balance the needs for social stability on the one hand, with the needs for the free exchange of information on the other.

B. Recommendations for International Funding Agencies

The Government has established its own development management priorities and may wish to invite assistance from bilateral and multilateral development partners (see Appendix 3 for a list of current and ongoing projects). Opportunities for collaboration exist in each area of development management. First, in the area of public financial management, multilateral agencies such as the World Bank and the International Monetary Fund have been involved in providing assistance for improved public financial management for many years. International funding agencies could continue to be involved in reform of the taxation system, budget reform, assistance to develop more effective forecasting models, and assistance to study improvements to the system of intergovernmental transfers. They may also consider providing assistance for broadly based training programs that provide training in the concepts and practices of good community governance, including financial management, service delivery, legal and property rights, public investment, community planning, improving institutions, and human resource productivity. Strengthened local governance capacity is especially needed in the western regions.

Second, scope for collaboration in the area of public administration could focus on helping the Government reduce and eliminate corruption. The Government has made substantial progress in this area, and assistance is welcome. International funding agencies may consider technical assistance to encourage drafting laws that require public hearings and other forms of participation in policy making and that lay down processes for the hearings. They may increase support to the Discipline and Inspection Commission, the Party's policy-making body for anti-corruption, the national security system, the judiciary, the Procurate (from national to county levels) and the Ministry of Supervision, in charge of supervising public administration. They may also consider providing support for drafting laws to break up monopolies and foster competition.

Third, funding assistance with drafting and reviewing drafts of laws may be considered. International funding agencies could also help with developing a more reliable citizens' complaint system and providing additional training for lawyers and judges. International funding agencies might consider assisting the Government to establish more effective consultative mechanisms in drafting and reconsidering regulations. International funding agencies may also consider assisting government agencies to draft their own procedures for making and applying rules and consider assisting the expansion of legal aid systems in the west. To strengthen the regulatory system, continuing reform of the statistical system is also necessary to ensure that investment, pricing, and marketing decisions are based on accurate information. International funding agencies may consider working with the NBS or local bureaus to improve the collection and handling of statistical data.

Fourth, many international funding agencies have experience in providing assistance to support alternative public service delivery, under the rubric of new public management systems. Small projects could be established, especially in the west, to experiment with some of these systems, while at the same time strengthening local governments' capacity to manage the systems effectively. Training of local officials would be needed.

Fifth, development of the private economy is moving ahead, but is still restricted by the country's traditional preference for the public sector. International funding agencies can assist by carrying out joint projects with NGOs that are committed to the private sector, such as the All-China Federation of Chambers of Commerce. International funding agencies could also help provide credit guarantee systems and microfinancing for SMEs. This could be done through a commercially viable vehicle to demonstrate the opportunities to other potential lenders.

Sixth, international funding agencies have already provided some assistance in the area of corporate governance, but much more could be done (see Appendix 2). Agencies may consider projects in particular corporations to encourage managers to adopt international best practices. International funding agencies could also assist in designing incentive systems for the implementation of appropriate corporate governance structures. They may also consider providing assistance for regulators such as the China Securities Regulatory Commission in designing packages of incentives for implementing corporate governance best practices.

Seventh, some international funding agencies, such as the Ford Foundation, have specialized in providing assistance to strengthen civil society and the capacity of NGOs in providing services to the public and helping the Government implement policy. Projects that focus on particular NGOs in specific geographic regions have been the norm. Perhaps a more holistic approach to the development of NGOs is now called for, which looks at issues such as their capacity to participate in policy making to improve the effectiveness of public policy.

C. Implications for ADB Action

To determine ADB's program of action for the PRC, resources should be targeted to interventions where ADB governance work can contribute important contribution to poverty reduction, where there is strong Government ownership of and long-term commitment to the development agenda, and where ADB's comparative advantage and value-added can be clearly demonstrated.

The development management agenda in the PRC is large, and to be effective ADB should focus on a few areas identified by the Government and build on ADB's expertise and strengths. ADB has been particularly effective in areas such as reforming public finance,

banking supervision, and risk management; strengthening government auditing and accounting systems; assisting with legal reforms, especially with economic laws, for instance, amending company law and drafting a new bankruptcy law, and with regulatory reform, such as drafting securities law; and assisting in the further growth of the state business and the private sector through further development of the insurance sector, SME credit systems, and financial policy mechanisms for SOEs.

Given the Government's aid management system, which restricts borrowing for projects that do not generate revenue, ADB will be restrained from lending for governance initiatives and will need to mobilize concessional cofinancing to be involved in any major governance loans. Therefore ADB should look for opportunities to leverage the use of scarce resources through strategic alliances and partnerships with other international funding agencies and the effective use of trust funds and other complementary financing schemes.

ADB's technical assistance activities in the PRC will also face resource constraints. The potential technical assistance budget allocation for Governance TA work in the PRC will be approximately \$2 million per year. To expand the modest available resources ADB will need to adopt a three-pronged approach: (i) improving the governance components of its infrastructure loans (for example, for privatization and tariff reform) and reducing extrabudgetary fees; (ii) increasing the PRC's participation in regional and subregional technical assistance initiatives, for instance, Anti-Corruption Action Plan, Decentralization, and Harmonization of Customs Procedures; and (iii) adopting a methodology that relies on high-impact interventions at the policy level and on policy dialogue to promote necessary reforms. ADB will need to work closely with the Government to identify strategic areas for significant impact under advisory and economic and sector work.

Given the importance of improving the institutional and legislative infrastructure for building a market economy, ADB should continue its work to help the Government draft procedures for government agencies on making and applying rules. It should also continue its work to strengthen public financial management institutions, particularly at the subnational level, draft economic laws (such as a revision of the 1995 Budget Law), and strengthen the regulatory framework for a market economy. ADB can also be effective in promoting a rules-based, international standards environment for business.

Developing the west and facing the challenges of the WTO membership are high priorities for the Government and should continue to be reflected in ADB's program of action. ADB is currently providing assistance to help the Government revise laws and regulations that are in conflict with the WTO. The PRC has a mediation system for resolving disputes that works well; however, as the PRC is further integrated into the world economy through accession to the WTO, the significance of the formal court system will likely increase, especially for resolving commercial disputes.⁴⁰ Support to improve the courts' capacity for dispute settlement or similar projects should be considered. In the future ADB should make efforts to ensure that policy recommendations and structural reforms in its sector loan work are consistent with the WTO rules.

⁴⁰ Effective 1 October 2002, the supervision powers of the courts extend to cover administrative cases involving international trade. In an effort to better protect the rights of local and foreign litigants, any person or group suspecting a violation of their rights by government departments—in regard to international trade—will be entitled to bring these before the courts.

As the courts become more important, further development of the country's legal aid system to permit all citizens, including the poor, to access the courts will be necessary. Given ADB's expertise in legal and regulatory areas it may consider assisting further development of the legal aid system, especially in the west. Such a project would clearly assist the poor.

Although the Government has waged a fierce struggle against corruption, more remains to be done. ADB has successfully provided assistance for the development of the accounting and audit system, which is critical for accountability. Further reform in this area to strengthen the capacity of the CICPA and other professional organizations to regulate the profession and raise accounting and auditing standards is necessary. ADB should also continue its efforts in encouraging the PRC to become a signatory to the ADB-Organization for Economic Cooperation and Development Anti-Corruption Action Plan and the ongoing initiative involving 18 signatory Asian countries that are implementing country-specific reforms.⁴¹

Development of the private economy in the PRC is moving ahead, but is still restricted by the country's traditional preference for the public sector. ADB can assist by continuing to sponsor and publicize research on impediments to the development of the private sector and through its work on the reform of economic law and regulation to ensure a more level playing field. Creating a more competitive environment will bring about the redundancy of ineffective SOEs more quickly. Thus ADB may also help accelerate SME development by helping the government become more of a service provider to SMEs by providing marketing assistance, export insurance, consumer surveying services, advertising services, training, and increased capitalization of SMEs through innovative financing windows. This could be done through ADB's Private Sector Department funds as a viable vehicle for demonstrating the opportunities to other potential lenders and could be focused on the west.

In addition to these more traditional activities for ADB, two additional areas are important to development management in the PRC. First, developing sound corporate governance practices is crucial for further economic growth. ADB may assist government departments in designing appropriate incentive systems for implementing sound corporate governance structures. ADB can also assist utilities regulators through utilities loan projects in designing packages of incentives for implementing corporate governance best practice. Second, intergovernmental fiscal reform should be part of ADB's strategic policy agenda. Providing policy influence through modest technical assistance support to institute a better fiscal transfer system in the PRC could have far-reaching impacts.

Finally, ADB should continue to improve its connectiveness to civil society, increasing its legitimacy by involving it in consultations and supporting NGO conferences. Where possible ADB can strengthen their capacity by contracting services in loan projects to NGOs, supporting them to undertake domestic consultancies, and commissioning economic and sector work to civil society research institutes. NGO participation in ADB projects would demonstrate their potential effectiveness as alternative suppliers in service delivery and development work to the Government.

⁴¹ RETA 5999's ADB-OECD Anti-Corruption Initiative - "Anti-Corruption Action Plan for Asia and Pacific" is available on ADB's website and has been translated into Chinese.