

EXECUTIVE SUMMARY

The fundamental development management challenge facing the Government of the People's Republic of China (PRC) is to implement reforms of the state structure so that it is appropriate for a market economy, while at the same time maintaining both economic growth and social stability. Economic growth is a prerequisite for the PRC to substantially achieve its goal of reducing poverty. Both the State and society play key roles in this goal.

The role of the State is to organize efficient and effective markets, remedy market failures, and develop human resources. In transition economies such as the PRC, the State also has an obligation to mitigate the hardships caused by the transition. Reinventing the State to fulfill these roles effectively is a major development challenge.

Economic growth also depends on society's efforts, and therefore requires the State to 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 ADB defines governance as Sound Development Management. This is an 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 a management approach helps secure the effective markets that are necessary for economic growth and also enables nonstate actors to contribute to the development process. The Government of the PRC subscribes to the principles of sound development management. Evidence of the country's commitment may be found in the 10th Five-Year Plan (2001–2005), the Constitution (1982, amended), and various organic laws.

Sound development management has substantial direct and indirect linkages to poverty reduction. Poverty reduction, a principal goal of the PRC and the principal goal of the Asian Development Bank (ADB), depends on effective markets and the environment for growth with significant redistribution of the beneficial effects. Effective markets in turn are determined by economic and noneconomic factors. The goal of this report is to assess key factors that impinge on markets and inhibit growth. It first examines the structure of the State and then discusses such key issues as public financial management, core government functions, the interface between the public and private sectors, and the development of civil society.

During the past 2 decades the PRC has given economic development top priority. Economic reforms have included welcoming foreign investment, implementing an export-led growth strategy, decollectivizing agriculture, decontrolling prices, and replacing central planning with a market economy. As a result of these policies, economic growth has been short of spectacular. However, economic reform has been accompanied by increasing unemployment and dislocation, and a growing migrant workforce that is generally not entitled to education, health, and welfare benefits. Economic development has also been accompanied by increasing income disparities between urban and rural areas and between the western region and the east coast. The Government has designed new policies to correct these problems, such as the "go west" campaign, and is now implementing these policies (herewith referred to as "west"). The

country also faces challenges with its accession to the World Trade Organization (WTO), which will require key components of the economy, such as agriculture and the state-owned enterprise (SOE) sector, to become globally competitive. Development management should enable economic growth, and focus particularly on facilitating markets and improving the interaction between the economy's key actors—Government, nonstate sector, workers, and the financial system. The task of this report is to identify and suggest solutions to any development management impediments to sustained economic and social growth.

The PRC's political institutions are well entrenched and functional. They permit citizens to participate in policy making through various channels such as public hearings, legislative hearings, and advisory committees. Nevertheless, the Government could strengthen the institutionalization of these channels by requiring officials to consult citizens during the process of making laws and drafting rules. The Government could also consider a law on government information transparency.

The Government has made significant progress in the reform of public financial management. During the last 3 years the Ministry of Finance has embarked on a wide-ranging set of reforms that include introducing new procedures for budget preparation and approval—using a new budget classification scheme—and improving monitoring and auditing. A new treasury management system is under preparation, and the Government has passed a Procurement Law, a decisive step in adopting transparent and indiscriminative practices. However, further strengthening of the revenue-generating mechanism, especially the tax collection system, is needed. The report recommends a review of the value-added tax to see whether it could become a tax on consumption rather than on production and a review of enterprise income tax preferences to see whether they can be reduced. To better use the budget as a management tool, extrabudgetary funds should be brought into the budget. Improving the capacity to forecast revenues and strengthening the oversight role of the National People's Congress are also recommended. Finally, the Government should consider further reforming the system of intergovernmental transfers to ensure that they reduce the problem of growing regional income disparities.

In practice, local budgetary autonomy is limited by many spending mandates from the central Government, local governments' lack of taxing powers, and their dependence on transfers from the central Government. Despite the 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. Moreover, many local governments lack the capacity to manage the responsibilities delegated to them by the central Government. Resolving these problems and improving local governments' capacity to manage development would significantly strengthen public financial management.

The system of public administration underwent significant reform in the 1990s, but despite restructuring and downsizing the Government, the administrative system remains highly compartmentalized. Improved coordinating mechanisms could enhance efficiency and reduce policy inconsistencies; the Ministry of Finance could play a more active role in determining the overall size and cost of the public sector. Furthermore, the authorities have established a new civil service system that is based on open competition, but abuses of the competitive selection system are ongoing and should be eliminated, and the Government's vigorous attack on corruption should continue. The Government should rotate more highly qualified officials to the poorer western regions of the country to improve local administrative capacities. It should also raise civil service compensation to bring it in-line with the private sector, to improve motivation, and to reduce the temptation of corruption. In addition, it should institutionalize the system of

popular participation in policy making by requiring public hearings, opening legislative hearings, and soliciting opinions.

The importance of improving governance at the local level is becoming a key development challenge. Improving the capacity of local governments to provide public goods and services, collect revenue and distribute local resources, implement regulations, control land use rights, and enhance investment and productivity will be a major area of intervention in the medium term. Strengthening local governance will be a significant factor in enhancing rural economic development and improving the welfare of rural households.

Considerable progress has been made in reforming the PRC's legal and judicial systems. Reforms have included expanding the number of lawyers and judges, improving law drafting capacities, improving the system of consultation on draft laws and their amendments, strengthening the capacity of the National People's Congress to consider laws, adopting educational and training qualifications for judges, and taking steps to ensure judges' impartiality. The legal process is also undergoing change, including upgrading the efficiency and quality of trials, improving regulations on evidence, and creating a computerized database to manage the records of court proceedings. The Government still needs to address the shortage of lawyers, weaknesses in law drafting capacities, and weakly institutionalized consultation mechanisms. Laws are characterized by inconsistencies and law enforcement by arbitrariness, and citizen complaints are often handled ineffectively. The Government should also strengthen its rudimentary legal aid system by, in particular, addressing understaffing and underfunding problems that impair its capacity. It should deal with the problem of judicial localism perhaps by creating a system of centrally financed national courts in the localities. Pay and other incentives for judges should be substantially improved. Despite the substantial progress that has been achieved during the last decade, the rule of law is not the norm because the State does not act as any other actor before the law.

Recent reforms have witnessed the growth of the regulatory state to manage a market economy. Central and provincial governments have promulgated thousands of new rules and regulations and established many new regulatory agencies; however, problems of clarity, consistency, arbitrariness, and lack of transparency are apparent 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 in part because agencies often issue regulations to empower themselves rather than to provide reliable guidance to affected parties. Dependence on local governments and/or on the collection of fines for funding has affected regulatory agencies' capacity to carry out their duties. Although redress mechanisms exist, their scope is limited. Public hearings on regulations are increasingly common, although voluntary. Corruption and noncompliance sometimes undermine the implementation of regulations. Although the Government has addressed these issues, more work remains to be done.

Sound development management is characterized by the efficient and effective delivery of public services. Many local governments have adopted new and innovative public service delivery systems that have included contracting out, franchising, and privatization, but many public services are provided by monopolies that do not permit citizens to realize the benefits of competition. Thus, to improve efficiency, greater efforts to reduce monopoly and increase competition are required. Further, despite considerable restructuring, the Government still provides many services that could be more efficiently delivered by nongovernment organizations (NGOs). Moreover, many agencies still use regulatory power as an instrument to protect and promote departmental or local interests. Such systems create rent-seeking

opportunities for public officials who use their discretionary power to extract payments and other forms of “contributions” from clients. Finally, a lack of transparency hinders attempts to hold agencies accountable for the delivery of public services.

Sound development management requires accountability in the sense that officials are accountable for their behavior and responsible to the entities from which they derive their authority (People’s Congress or the Communist Party of China). Bureaucratic accountability systems are reasonably well developed and the Government has implemented an official responsibility system at all levels. Auditing and accounting standards have been adopted that conform to international practice, and the statistical system is increasingly reliable. Nevertheless, in some instances these standards are arbitrarily required and are only weakly implemented.

Economic development depends on the combined efforts of the Government, NGOs, and the private sector. The Government has recognized the important contributions of the private sector to sustainable economic growth, but in many respects the bias toward state-owned property and the public sector remains and the private sector continues to suffer from many problems. These include (i) laws protecting the private sector, including a law to guarantee equal treatment, are incomplete, outdated, or nonexistent; (ii) uncoordinated policies sometimes cause confusion among private entrepreneurs; (iii) private entrepreneurs are discriminated against in entry to the market and require stronger regulation of the market to ensure order, a condition that benefits all business; and (iv) financing is often not available to the private sector, which is concentrated mostly in small and medium enterprises (SMEs). SOEs receive the majority of the allocations available through the formal financial system, while SMEs receive a much lower share than warranted by their importance in the overall economy (OECD). Solutions to these problems must be found to further develop the economy. The Government should redouble its efforts to focus on its new role as a service provider to both public and private entrepreneurs.

Creating modern economic enterprises involves improving the structure of corporate governance. The Government has expended considerable effort to reform the country’s SOEs. These reforms have granted SOEs autonomy and sought to separate enterprises from the Government through changes to their ownership and management structures. However, many SOEs are not performing well. The PRC’s accession to the WTO and growing numbers of well-informed domestic shareholders will put pressure on the regulatory authorities to strengthen the roles of shareholders, boards of directors, and boards of supervisors. Moreover, remuneration packages for managers should be tied to enterprises’ performance, and transparency in the way enterprises are governed should be improved dramatically.

Sustainable social and economic development requires the Government to partner with civil society in producing goods and services to meet community needs. As the Government has shed many responsibilities, especially for social services, the authorities have encouraged a kind of NGO unique to the PRC to fill the gap. The 1990s witnessed an explosive growth of NGOs operating in such areas as population, environment, poverty reduction, education, health, rural development, resource conservation, social services for the elderly and the disabled, and related gender issues. Many of these NGOs have a close and cooperative relationship with the Government (indeed, the Government has actively encouraged establishing most of them). This relationship has varied considerably, with some organizations exercising considerable autonomy in practice. Nevertheless, the Government regulates their activities and discourages establishing nationwide NGOs. Their capacity to participate in the policy process should be strengthened and their activities regulated by a law on NGOs.

Access to information is intimately related to economic development. Without access to information entrepreneurs cannot make informed investment and marketing decisions, which leads to inefficiencies. Although unprecedented numbers of PRC citizens now have access to the media and the Internet, government control in these two areas continues to be tighter than in most market economies.

The PRC's accession to the WTO will put pressure on the Government to solve these problems. The breadth of its commitments to open its export markets and to liberalize access to its domestic economy will permit more than economic gains. The WTO will accelerate access to technology significantly advance the country's legal and judicial system, and fast-track market disciplines (OECD).

The report examines these synthesized governance issues in depth and concludes with a discussion of recommendations for the Government, the development community, and ADB.

Recommendations for International Funding Agencies

Opportunities for funding/development assistance can be found in many areas:

- In the area of public financial management, multilateral agencies such as the World Bank and the International Monetary Fund have been intimately involved in providing assistance for improved public financial management for many years.
- International funding agencies should 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.
- Development partners may consider assistance to strengthen local governments' capacity to manage development. Strengthened local capacity is especially needed in the western regions. To this end broadly based training programs that improve the governance skills of local community leaders will be critical in strengthening development administration in the next decade.
- The scope for collaboration in the area of public administration may focus on helping the Government reduce and eliminate corruption. Assistance in drafting laws that require public hearings and model participation in policy making, and that lay down processes for the hearings is needed.
- International funding agencies may also consider support for drafting laws to break up monopolies and foster competition.
- In the legal and regulatory area assistance is needed to support the development of a more reliable citizens' complaint system and provide additional training for lawyers and judges.
- International funding agencies may help the Government in establishing more effective consultative mechanisms in drafting and reviewing regulations.

- International funding agencies could provide support to government agencies in drafting their own procedures for making and applying rules and consider assisting the expansion of legal aid systems in the western regions, as most legal aid centers are operating in coastal regions.
- To strengthen the regulatory system, continuing reform of the statistical system is necessary to ensure that investment, pricing, and marketing decisions are based on accurate information. International funding agencies may work with local offices of the National Bureau of Statistics to improve the collection and handling of statistical data.
- International development partners have experience with providing assistance to support alternative public service delivery systems, such as contracting out, public-private partnerships, and privatization. Small projects could be established, particularly in the west and central regions, to experiment with some of these systems, while at the same time strengthening local governments' capacity to manage the systems effectively.
- Development of the private economy is moving ahead, but is still restricted by the traditional preference for the public sector. Additional opportunities present themselves for 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 may also increase their involvement in developing credit guarantee systems and microfinancing for SMEs. This could be done through a commercially viable vehicle to demonstrate the opportunities to other potential lenders.
- International funding agencies have already provided some assistance in corporate governance, but there are many opportunities for action. Development partners may assist in designing incentive systems for implementing appropriate corporate governance structures. Additional support to regulators such as the China Securities Regulatory Commission in designing packages of incentives for implementing corporate governance best practice is also needed.
- Some organizations, 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 to help the Government in implementing policy. Future assistance should focus on capacity building to help NGOs participate in policy making to improve the effectiveness of public policy. Development partners may also increase capacity to contribute to further development of the private sector.

Recommendations for ADB

To determine ADB's program of action for the PRC, resources should be targeted to interventions where ADB governance work can contribute to poverty reduction, where there is strong government ownership and long-term commitment to the development agenda, and where ADB's comparative advantage and value-added can be clearly demonstrated. ADB should maximize the impact of its operations and look for opportunities to leverage the use of scarce resources through strategic alliances and partnerships with other international development partners and the effective use of trust funds and other complementary financing schemes.

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 existing expertise and strengths. Working with the Government to identify the most appropriate areas for ADB assistance is essential. ADB has been particularly effective in areas such as reform of public finance, legal (especially economic laws) and regulatory reform, auditing and accounting reform, and private sector development.

Developing the west and facing the challenges of the WTO membership are high priorities for the Government and should be reflected in ADB's program of action. Conducting training for provincial and local-level officials to improve their capacities, particularly in areas that influence poverty reduction, through the ADB Institute is recommended. ADB may also address regional inequalities through activities that enhance fiscal transfers and more equitable resource distribution from the central to local levels.

Given the importance of public financial management and ADB's expertise, ADB should work with the Ministry of Finance in identifying appropriate areas where additional assistance will have a significant impact. These areas may focus on assistance in drafting economic laws, such as revising the 1995 Budget Law, or in strengthening the regulatory framework for a market economy. Such assistance could include helping the Government draft procedures for government agencies in making and applying rules.

The PRC has a mediation system for resolving disputes, which works well. However, as the PRC is further integrated with the world economy, especially through accession to the WTO, the importance of the formal court system will likely increase in significance, especially for resolving commercial disputes. As the courts become more important, further development of the legal aid system to permit all citizens, including the poor, access to the courts will be necessary. Given ADB's expertise in the legal and regulatory areas, it may consider assisting the further development of the legal aid system, especially in the west. Such a project would clearly benefit the poor.

ADB has successfully provided assistance for the development of the accounting and auditing system, which is critical for accountability. Further reform in this area is necessary to strengthen the capacity of the Chinese Institute of Certified Public Accountants and other professional organizations to regulate the profession and raise accounting and auditing standards. Continuing reform of the statistical system is also needed to ensure that investment, pricing, and marketing decisions are based on accurate information. ADB may consider complementing the work of other development partners in assisting the National Bureau of Statistics or local bureaus to improve the collection and handling of statistical data, which is critical for ensuring public accountability.

Development of the private economy is moving ahead, but is still restricted. ADB can assist by continuing to sponsor and publicize research on the impediments to the development of the private sector and, through its work on the reform of economic laws and regulations, helping ensure a more level playing field. ADB may also assist in providing credit guarantee systems and financing for SMEs. ADB should continue to support the development of civil society as an alternative vehicle for delivering social services and in support of its role in improving accountability. ADB should work with other development partners in developing a government-led framework for civil society and an NGO law.

In addition to these more traditional activities for ADB, two additional areas are critically important for development management in the PRC. First, developing sound corporate

governance practices is crucial for further economic development. ADB may support government departments in designing appropriate incentive systems for implementing sound corporate governance structures. ADB may also support such regulators as the China Securities Regulatory Commission in designing packages of incentives for implementing corporate governance best practice. Second, while the Government has waged a fierce struggle against corruption, more remains to be done. In particular, ADB could consider a project to create and maintain a more enabling environment for clean government. In both these areas there is much scope for working with other development partners. ADB should continue its efforts to encourage the PRC in becoming a signatory to the ADB-Organization for Economic Co-operation and Development Asia-Pacific Anti-Corruption Initiative, an ongoing program of 19 Asian countries working collaboratively on anticorruption activities within a collective Action Plan.

Sound development management is essential for economic and social development. 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 many key areas, including public financial management, public administration, the legal and judicial system, public service delivery, public accountability, development of the private sector, corporate governance, and the development of emerging civil society. Removing the remaining largely noneconomic factors that hinder economic growth will improve the development management situation in the PRC.