

POLICY, LEGAL, AND INSTITUTIONAL FRAMEWORK FOR PRIVATE SECTOR DEVELOPMENT

A. POLICY FRAMEWORK

I. Background

Official documents define the PRC's economic system as a socialist market economy, although the economy also falls within the prevailing international definition of a "transition economy"—a centrally planned system evolving toward market institutions. In this context, it is important to review briefly how the Government's perception toward the private sector has changed over time, as well how these changes have found expression in relevant laws, regulations, and policy pronouncements.

For more than 40 years, beginning with the establishment of the PRC in 1949, the private sector lacked legitimacy in the eyes of the Government. Although the Government embraced the importance of the private sector in the economy, a lingering suspicion about the role of the private sector and private property rights and the need for reforms to be advanced by consensus led to a more cautious and gradual approach to reforms.

Decentralization also has contributed to the unique market transition in the PRC. Since 1958, the PRC economy has been organized regionally, which enables isolation of different reforms and local experimentation, primarily in rural areas. Although this system enables flexibility, it requires the cooperation of local governments, who may have vested interest in the status quo, to ensure success.

In the recent past, private sector development (PSD) can be divided into four phases: (i) the development of individual businesses following the official revival of private business, 1978–1985; (ii) the emergence of the private sector as a supplement to the public sector, with the rise of privately run enterprises, including a large portion of "red hat" (disguised state sector) firms, 1986–1991; (iii) the performance by the private sector as an important component of the economy, with the rapid development of private firms and an emphasis on a rule-based system and the building of market institutions, 1992–2000; and (iv) the post-WTO era. Appendix 3 shows the evolution of the Government's private sector strategy over the past 20 years, including government perceptions of the private sector and the legal basis and constitutional status of the private sector.

After the 3rd Plenum of the Chinese Communist Party's 11th Central Committee first began market-oriented reforms in 1978 (soon after the official conclusion of the Cultural Revolution), individual enterprises were revived as a way to respond to mounting pressures of unemployment and economic stagnation (International Finance Corporation [IFC] 2000b). The Government called the "individual economic sector" a necessary "supplement" to the state and collective sectors and proceeded to introduce reforms incrementally. New policies were tried in selected provinces, prefectures, counties, and firms and involved specific sectors. The main private players were self-employed individual enterprises. Experiments that were successful were replicated.

In 1987, the 13th National Party Congress of the Communist Party of China (Communist Party Congress) officially recognized the “private economic sector” as a necessary supplement to the state sector. The following year, for the first time, the rights and interests of the private economy were protected by an amendment to the Constitution. This spurred an increase in privately run enterprises, which received an official category designation in 1988. During this period, the treatment private business entities received often depended on the whim of local authorities, which is an important reason why so many privately run firms opted to register as collectives or TVEs.

The next stage of PSD is characterized by the 14th Communist Party Congress in 1992, which endorsed a “socialist market economy” as the PRC’s reform goal. In 1993, the Government designed the first grand strategy for transition to a market economy that called for the creation of a “level playing field” through a rule-based market system that addressed property rights, ownership issues, and the building of market institutions (IFC 2000b). Following the official recognition of the private sector as an important component of the economy at the 15th Communist Party Congress in 1997, the Constitution was amended in 1999 to recognize the role of the private sector and provide a basis for future changes in the legal, policy, and regulatory environment to support development. In 1999, the NPC adopted the Law for Individual Wholly Owned Enterprises.

A new era for private enterprises began in 2001. PSD was given further impetus when the Government facilitated the registration of private enterprises. The minimum capital requirement for private businesses was lowered to CNY1 and requirements for bank certificates and other bureaucratic approvals to prove sufficient capitalization of a firm with a limited number of employees were eliminated. On 1 July 2001, at ceremonies marking the 80th anniversary of the founding of the Communist Party, President Jiang Zemin announced that for the first time private entrepreneurs could become party members.⁵ Another significant event was the PRC’s accession to WTO that obligates the Government to extend foreign-owned businesses rights and privileges that are currently denied to domestic private firms.

2. Restructuring of State-Owned Enterprises

a. Development of the Nonstate Sector

The development of a vibrant nonstate sector preceded SOE restructuring. The nonstate sector emerged in the 1970s through reform of the agriculture sector and adoption of measures to “generate huge increases in productivity, income and output with negligible state investment (Cao 2001).

Prior to economic reforms, a collective farming system known as the people’s commune system, which replaced private farming in rural areas of the PRC in the late 1950s, existed. Under this system, there was a three-tier ownership structure with people’s communes at the top, production brigades in the middle, and production teams at the bottom. Individuals were not allowed to own major means of production or conduct nonagricultural business (Shuhe Li 2000) In 1979, Draft Regulations on the Development of Commune Brigade Enterprises were adopted by the State Council. These regulations provided local governments and households with some autonomy from the Central Government, replaced the people’s commune system with the township village system, and developed the household responsibility system. Assets formerly owned by people’s communes were sold to farmers at low prices, enabling household-based business to accumulate the necessary start-up assets at low cost (Shuhe Li 2000). Farmers were granted individual leaseholds on land formerly used by communes and a high degree of autonomy and flexibility in production and sales, provided that certain state quotas were met. Surpluses generated over established quotas

⁵ Jiang Zemin’s “Three Represents Theory,” which provides, among other things, that the party must represent the development of all of the PRC’s advanced productive forces (including private businesses), opened the door to letting businessmen join the Communist Party.

were allowed to be sold at free market prices. Production output increased enormously and generated a very high rate of household savings and increased living standards.

In the early 1980s, individuals were permitted to conduct business in agriculture-related sectors, while communes, brigades, and production teams were allowed to conduct business in some nonagriculture sectors. In 1984, the Central Communist Party and the State Council issued the Report on Creating a New System in Commune Brigade Enterprises, which renamed commune brigade enterprises as TVEs, relaxed restrictions on collective businesses, and allowed private businesses (nonstate sector firms, collectives, and privately owned firms) to operate outside of agriculture (Shuhe Li 2000).

b. Restructuring of State-Owned Enterprises

When SOE reforms were initiated in 1978, emphasis was placed on the gradual termination of government support for working capital through directed credit from state-owned commercial banks (SOCBs). However, ongoing concern about the ability of SOEs to remain solvent and the increasing amount of available private funds led the Government to allow SOEs to convert into shareholding companies.

The restructuring of SOEs continues to be a complicated process based upon decentralization of the economy, the role of local governments and their competing claims over property rights (Section II.A.3. Ambiguous Private Property Rights), and the impact on the PRC's enormous workforce (Jukka 1999). The program for restructuring can be divided into three stages (DFID 1999).

- (i) Stage 1 (1979–1984) involved the expansion of operating and management rights of SOEs, giving them greater control over wage setting and production decisions.
- (ii) Stage 2 (1985–1993) involved the separation of ownership from operational control, additional increases in the responsibility of enterprise managers, enterprise responsibility for profits and losses, experimentation with joint stock companies, removal of price controls, adoption of programs to address social security concerns, and liberalization of the labor market.
- (iii) Stage 3 (1994–ongoing) involves the ongoing adoption of policies aimed at developing a modern enterprise system in which SOEs adopt modern methods of corporate governance and become market oriented, and related reforms in the banking and social sector.⁶

At the end of 1998, the Government launched a 3-year SOE bailout program to help weak large and medium SOEs and encouraged debt-to-equity swaps to transfer their long-standing debt to SOCBs, to asset management companies (AMCs). In furtherance thereof, the Government announced that for the first time, foreign investment could be used in asset restructuring of SOEs.⁷

In June 2001, the State Council adopted a regulation requiring SOEs to sell state-held shares when issuing new equity and pay the proceeds into the newly established National Social Security Fund (NSSF).⁸ However, subsequent stock market declines, which reflected shareholder concerns with the dilution in the price of existing shares, caused the Government to indefinitely delay such

⁶ The Government is pursuing social security reforms to support SOE restructuring. With ADB assistance, social security reforms are being pilot tested in Liaoning Province, which has one of the largest concentrations of SOEs in the PRC (ADB 2001c). A National Social Security Fund was established in 2000 and a social security law is being drafted with ADB assistance.

⁷ In 1998, the SETC promulgated Asset Restructuring by SOEs Using Foreign Investment Tentative Provisions. Article 2 states that foreign investments may be used in (i) the direct investment and acquisition of an SOE by foreign investors; (ii) the provision of working capital; and (iii) the repayment of the debts of the enterprise.

⁸ The NSSF raises funds primarily through the sale of government shares in SOEs and budgetary allocations by the Ministry of Finance (MOF). This Fund was established to address shortfalls in the Government's pay-as-you-go social security system resulting from the inability of bankrupt SOEs to contribute to provincial social security pools. As of March 2003, the Fund controlled about CNY80 billion (\$9.7 billion). New regulations introduced in December 2001 allow the Fund to invest up to 40% in equities and an additional 10% in corporate bonds. Previously, investment was limited to bank deposits or government bonds (Economist Intelligence Unit 2003).

sales (Economist Intelligence Unit 2002, Shirai 2002). In January 2002, the Government announced new proposals to sell state-owned shares that immediately led to a sharp decline in share prices and the Government's subsequent decision to postpone such sales.

In February 2002, the Government announced a new *Foreign Investment Industrial Guidance Catalogue* and encouraged foreigners to take part in key SOE reforms. In June 2002, in response to the pressure to slow the pace of public offers of additional state-owned shares, provisional regulations were issued by the China Securities Regulatory Commission (CSRC) to allow companies to sell additional shares only if (i) their weighted average net return on assets over the last 3 years is at least 10%; (ii) their assets-liabilities ratio is not less than the average industry level; (iii) projects funded by their previous share issues are 70% complete; (iv) where the number of new shares exceeds 20% of the total, approval of more than half the votes of shareholders holding tradable shares has been obtained; and (v) where the company's earnings drop by 50% or more after the additional offer, the main underwriter's underwriting business is curtailed or suspended (Shirai 2002).

In August 2002, the southern city of Shenzhen, with the support of the State Council, sold noncontrolling shares in five major SOEs in the energy, water, gas, transportation, and food sectors (Shenzhen Energy, Shenzhen Water, Shenzhen Gas, Shenzhen Public Transportation, and Shenzhen Food) through international tender (Southcn 2003).

In November 2002, the Government issued new regulations that became effective in January 2003, to clarify the regulatory framework for restructuring SOEs and unlisted companies with state shareholdings (other than financial institutions) by foreign investors through equity or asset transfers.⁹ Under the regulations, foreign investors are required to contribute capital, advanced technology, and business management experience to target SOEs, and prior to approval of such acquisitions, submit a comprehensive restructuring plan for the target SOE that includes, among others, a strategy for improving corporate governance and addressing employee concerns.

In November 2002, the CSRC and the People's Bank of China (PBOC) issued a joint circular to allow qualified foreign institutional investors (QFIIs) to purchase nontradable shares held by the Government and other institutions through public tender.¹⁰ As discussed in detail in Section IV.A.2.a, these shares account for more than two thirds of the PRC's stock market capitalization (Business Times 2002 and China Law and Practice 2003f). Procedures under this circular and related regulations allow foreign fund management institutions, insurance companies, securities companies, and other types of asset management institutions (e.g., commercial banks) that meet certain criteria (ranging from 5 years of sector-related experience for fund managers to 30 years experience for insurance companies, management of at least \$10 billion in assets over the last fiscal year, etc.) to apply for approval to invest as a QFII in A share listed companies.¹¹ Once approved, QFIIs are required to open a special domestic currency account with a domestic bank and use domestic securities companies while trading. Regulations govern acquisitions of controlling interests, minimum and maximum purchase (\$50 million, \$80 million), investment limits for each QFII (10% of the total), and aggregate percentage of shares held by all QFIIs held in a single company (20% of the total).¹²

New regulations that came into effect on 12 April 2003, which were prepared with ADB assistance, also clarify and restrict the scope of foreign corporate acquisition activity in the PRC.¹³ Among others, these regulations provide a framework for acquisitions of registered capital in limited liability companies, allow acquisitions with shares and capitalization of new FIEs with assets

⁹ *Use of Foreign Investment to Restructure State-Owned Enterprises Tentative Procedures* (China Law and Practice 2002).

¹⁰ QFIIs can also invest in listed convertible bonds, closed and open-end funds, and initial public offerings, additional share issues, and rights issues.

¹¹ See Section II.A.2.a. for a discussion of the A share market.

¹² As of April 2003, a number of foreign institutions have applied for approval to invest as a QFII including Morgan Stanley, Deutsche Bank, UBS Warburg, and Goldman Sachs. The CSRC has approved three foreign banks to act as a custodian for QFIIs (Citibank, Hong Kong Shanghai Bank of China, and Standard Chartered) and five domestic banks (Industrial and Commercial Bank of China [ICBC], Bank of China, Agricultural Bank of China [BOC], Bank of Communications, and China Construction Bank).

¹³ The CSRC issued new regulations in October 2002, followed by the issuance on 7 March 2003 of Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors by the former Ministry of Foreign Trade and Economic Cooperation and other agencies.

acquired from domestic enterprises, and create a new antimonopoly review process for foreign investors (China Law and Practice 2003a).

3. Ambiguous Private Property Rights

Private sector growth in the PRC has occurred despite the absence of clearly defined property rights. As discussed above (Section II.A.1. Background), prior to economic transition, there was no property rights system in the PRC. Consistent with the approach to market reform, transformation of property rights has been gradual—ambiguous property rights continue to be clarified and defined (Section III.D.1. Legal Status of Private Sector).

Although property rights are generally viewed as the exclusive ownership over specific assets, they can be divided into three components: (i) right to use specific assets (user rights), (ii) right to receive revenue from specific assets (extractor rights), and (iii) right to transfer specific assets through sale or gift (transfer rights). In the PRC, these components have been unbundled, separated, and delinked. The Government continues to retain user rights and transfer rights over property that has been sold. Public ownership prerogatives continue to exist and reside more often in provincial and municipal bodies than at the national level. TVEs cover a wide range of cases with some involving direct local government control, and others entailing leases to managers who enjoy substantial autonomy or private ownership with formal protection by TVEs.

Conversion of many TVEs to individual shareholdings has become popular in numerous localities. The merger of SOEs, bankruptcies, shareholdings, and sales of SOEs have helped formalize private property rights. Notwithstanding, formalization of property rights has not ended shared authority over user rights and transfer rights. As part of the agreement to transfer such rights, local governments often impose restrictions on the resale of assets or the firing of employees (Section II.A.2.b. Restructuring of State-Owned Enterprises).

Until recently, the Government continued to own rights and regulate/administer state assets leading to governance concerns, while control over such assets was fragmented. Although for some years state assets were supervised centrally or at the local level under administrative guidance of the National Administration Bureau for State Owned Property (NAB) or a variant of it at the provincial level, the NAB was subsequently abolished. The Ministry of Finance (MOF) became the state representative in SOEs, responsible for monitoring and evaluating SOE performance. The State Economic and Trade Commission (SETC), under the overall direction of the State Council, exercised macro management and direction over enterprises with state ownership and oversaw policies, guidelines, and restructuring programs for SOEs.

To address governance concerns and improve SOE performance, the State Asset Supervision and Administration Commission (SASAC), a ministry level body under the State Council, was recently created to administer state property, other than SOCBs (Section II.C. Institutional Framework). SASAC is responsible for dividing definitely the shareholding structure of firms that are either owned or co-owned by the Central Government and local governments and overseeing the sale of SOEs to foreign and domestic investors (Beijing Review 2003a). As discussed above, SOE reforms have stalled in recent years because the Government has not been able to clarify the ownership composition of approximately 180,000 SOEs worth an estimated CNY6 trillion (\$724.9 billion) (National People's Congress 2003). Initially, SASAC will oversee state assets in enterprises owned and controlled by the Central Government.

Provincial authorities will correspondingly establish SASACs. Under the authority of SASACs, state asset management institutions will be organized to preserve and increase the value of state assets. These institutions, which will not have any regulatory powers and will be legal appointees under a contract based system, will be authorized and approved by SASACs, which will supervise and administer these institutions instead of being directly involved in management and business.

4. Small and Medium Enterprises

The Government's commitment to the development of SMEs is reflected in a series of policies, action plans, and lawmaking initiatives.¹⁴ In May 1998, President Jiang Zemin commented that the development of SMEs should be considered an important part of economic strategy. Subsequently, in July 1998 an SME Department was established within SETC to strengthen the coordination of SME development support. SETC also chaired the National Leading Group for SME Promotion and Development. There are SME divisions at the provincial- and municipal-level economic and trade commissions in 24 provinces that have been instrumental in improving enabling conditions for the local business environment.

To directly address the constraints SMEs face in accessing financing, PBOC issued *Guidelines on Strengthening Credit Support to Efficient SMEs with Sound Credit Standing and Marketable Products*. The Guidelines require, among others, SOCBs to establish departments specifically responsible for serving SMEs. Commercial banks are also preparing to launch "onlending" services, through which they will offer long-term credit to regional banks for onlending to SMEs.

To improve SME access to finance, *Guidelines on Establishing SME Guarantee Systems* were adopted in June 1999 to enable the establishment of pilot credit guarantee companies (CGCs) in more than 70 cities (Box 2). Tax authorities exempt nonprofit credit guarantee and reguarantee institutions for SMEs from paying business taxes for 3 years. According to SETC, there are currently 300 CGCs nationwide (except in Tibet), of which 220 were granted tax exemptions based on the predetermined criteria. Among the 220 CGCs, 38% were private companies.¹⁵ Approximately CNY10 billion (\$1.21 billion) has been raised for guarantees that stand at 4–5 times leverage ratio.¹⁶ In addition, during the last 3 years, the Shanghai Municipal Government successfully established a new credit reporting system targeted at SMEs through commercial banks based on a prudential assessment of creditworthiness.

To support SME development and provide overall guidance, SETC set up the State Leading Group on Supporting SMEs with high-level representatives from MOF, PBOC, the Ministry of Science and Technology (MOST), State Administration of Industry and Commerce (SAIC), CSRC, and policy banks and commercial banks.

In August 2000, the State Council issued "policy measures" propagated by SETC to encourage and promote SME development. The Government identified 25 measures under eight broad categories: (i) fostering structural adjustment; (ii) promoting technology modernization; (iii) expanding support for fiscal policy; (iv) widening financing channels; (v) speeding up establishment of a credit guarantee system; (vi) setting up social service support system; (vii) creating a fair competition environment; and (viii) strengthening leadership and guidance. These policy measures are reflected in the new law on Promotion of Small- and Medium-Sized Enterprises (Promotion Law) that was adopted in June 2002. The new law, which took effect in January 2003, encompasses general principles supporting SMEs and specific services provided in the forms of funding support, technology innovation, and expansion of marketing and service systems, and should improve the enabling environment for SMEs. Under this law, a private enterprise or SOE that meets numeric requirements in terms of assets and personnel will be defined as an SME and entitled to tax exemptions or deductions depending on how many laid-off workers they hire. This new law and Shanghai pilot credit reporting system were supported through ADB technical assistance (TA). Another recently approved ADB TA will help develop policies and regulations in establishing the SME Development Fund, an alternative financing mechanism proposed in the new law (ADB 2000b and ADB 2002g).

¹⁴ The latest guidelines on enterprise size, as agreed upon by State Development Planning Committee (SDPC), the National Statistics Bureau, MOF, and SETC define medium enterprises as enterprises with annual sales of CNY50 million and general assets of CNY50 million and small enterprises as enterprises with annual sales of less than CNY50 million and general assets of less than CNY50 million.

¹⁵ SETC.

¹⁶ SETC.

Notwithstanding these developments, due to a less transparent historical policy environment in which many firms used to operate, as well as lack of information, many SMEs are not aware of recent policies that will benefit them, or they simply have no time to understand the new policies. There is thus a need for concerted efforts among government agencies and local governments to create a mechanism to publicize information regarding policy changes that affect SMEs.

Box 2:

Credit Guarantee Schemes in the PRC

Credit guarantee schemes (CGSs) are promoted by the Government to help facilitate bank lending to small and medium enterprises (SMEs) that lack assets or adequate financial records to obtain bank loans independently. Business organizations, local governments, and individuals are encouraged to establish CGSs. Because banks should be able to lower their risk of lending to SMEs by obtaining guarantees from the CGSs on all or part of their loans, the Government envisages a rising supply of formal finance to SMEs.

CGSs vary in terms of their size, scope, and quality of their activities. A majority of CGSs funded by the Government are not well structured; neither do they make decisions based on commercial considerations. Some appear to be assuming the credit allocation function of banks. The current structure of CGSs thus presents potential hazards to the financial system as risks are transferred from financial intermediaries to CGSs.

Few CGSs seem to be very active and large enough to have a meaningful effect on the volume of bank lending. Smaller CGSs have limited credibility with banks and need to use their own cash as collateral to induce banks to lend. Larger and more credible CGSs typically offer to guarantee loans up to CNY3 million (\$360,000). Some CGSs guarantee 100% of the value of loans. Guarantee fees range from 1 to 1.5% of the guaranteed amount.

CGSs employ project analysis and approval processes that are similar to banks but tend to be more flexible in analyzing investment projects because they seek additional credit information to support their business decisions and may use a local investigative agency for supplementary information about potential clients.

There is no central regulatory oversight of CGSs. ADB, through technical assistance (TA) 3543, provided recommendations on a legal and regulatory framework for CGSs, including the establishment of a central reguarantee program. Under TA 3493, ADB provided recommendations to the Shanghai Municipal Government to develop commercially funded CGSs in Shanghai.

Sources: ADB, 2000, 2001, 2002. ADB. 2002. Technical Assistance to the PRC for Private Sector Development. Manila; ADB. 2001. Technical Assistance to the PRC for Development of Financing Policies and Mechanisms for SMEs. Manila; and ADB. 2000. Technical Assistance to the PRC for Development of Small and Medium-Sized Enterprise Credit Support System. Manila.

5. Foreign Direct Investment

Government policy toward FDI has changed significantly in the last 20 years and evolved through several stages. In the initial stage from 1978 to 1985, foreign investors were restricted to export-oriented operations. This stage saw the establishment of “export processing” zones largely for Hong Kong, China businesses in Guangdong, the four original special economic zones (Shantou, Shenzhen, Xiamen, and Zhuhai), and with the subsequent addition of Hainan, all of which offered foreign investors preferential treatment such as tax incentives. The second phase,

1986–1991, provided a clearer policy direction exemplified in the draft list of industrial sectors to which FDI was encouraged, restricted, and prohibited. Foreign investors were also allowed to manufacture and sell numerous goods domestically.

In 1990, a new economic zone was created in Pudong, Shanghai. The Government also introduced legislation and regulations to encourage foreign investment into high-priority sectors (energy, communications, and transportation) and regions. Time restrictions on the establishment of JVs were repealed, assurances against nationalization were provided, and foreigners were allowed to become chairs of JV boards.

In 1991, the PRC became a member of APEC that provides for free trade and cooperation in the region. In 1992, the amount of FDI started to increase dramatically following Deng Xiaoping's announcement to further stimulate economic reforms by expanding the successful experiments into other regions in addition to the coastal cities, and the PRC began to attract much more FDI than other neighboring countries (Figure 1).

In the mid-1990s, the Government authorized the establishment of wholly foreign-owned enterprises, now the preferred form of investment. Previously foreign investors were required to form JVs with PRC firms to enter the market (American Embassy in the PRC 2002). Foreign banks were also authorized to open branches in Shanghai and foreign investors were allowed to purchase special B shares of stock listed on the Shanghai and Shenzhen Stock Exchanges (collectively Exchanges).¹⁷

From 1993 onward, major changes occurred in the nature of reform. Laws were revised in 2000 to ease export performance and domestic content requirements. The NPC endorsed the “go west” policy in March 2001. This policy is a priority in the Tenth Five-Year Plan (2001–2005) and is designed to address the substantial disparities in regional living standards that have emerged during the course of 20 years of reform when the strategic focus was on attracting FDI in the coastal region. Preferential measures to facilitate development in the western region include raising the Central Government's budget allocation for large-scale projects in this region and giving foreign-funded firms participating in the economic development of this region the same preferential policies as those located in the coastal economic zones.¹⁸

In April 2002, pursuant to the PRC's accession to WTO, new guidelines were issued to open more industries to foreign investment (Section II.A.6.c. WTO Accession). While ownership regulations continue to require domestic investors to have a controlling stake in companies in certain industries, these industries account for less than 6% of the total. Foreign investors are currently allowed to establish wholly owned subsidiaries in almost 90% of all industries.

6. Trade Liberalization

a. Import and Export Rights

The pre-reform trade regime in the PRC was initially dominated by 10–16 foreign trade companies (FTCs) that had a monopoly in the import and export of specific products. The number of FTCs was incrementally expanded with trading rights provided to branches of the FTCs controlled by the Central Government, regions, and localities, resulting in thousands of firms. JVs between domestic and foreign firms and firms located in the special economic zones were also allowed to trade. Subsequently, large producing firms began to gain direct foreign trade rights (Ianchovichina undated).

¹⁷ See earlier discussion (Restructuring of State-Owned Enterprises) on new regulations to permit foreign mergers and acquisitions of SOEs and privately owned enterprises and discussion, *infra*, in Section II.A.2.a on B share market.

¹⁸ See Draft TA Report on Attracting FDI to Western China, March 2003, Monash International, prepared under *Technical Assistance to the PRC for the Study of Foreign Capital Utilization for the Western Region*. Note that these measures do not yet appear to have had any significant impact on FDI based on the Government's current focus on infrastructure, poverty, and environmental protection projects.

Since 2002, the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) has lifted controls over import and export rights. However to obtain such rights, a firm is required to meet certain conditions such as a minimum registered capital over CNY5 million (over CNY2 million for high-technology companies) that was reduced to CNY3 million in 2003, and will be further reduced to CNY1 million in 2004 (China Daily 2002o).

Since early 2002, 32,000 domestic enterprises have been granted import and export rights. MOFTEC has also sent a draft proposal on granting FIEs full trading rights to the State Council for approval. Upon approval, 50,000 FIEs will be able to import and export products without being subject to state trading or designated trading (China Daily 2002o).

b. Barriers to Trade

During the 1990s, the PRC made substantial progress in reducing the number of nontariff barriers to trade. The number of products subject to quotas and licenses was estimated to have fallen from 1,247 tariff lines in 1992 to 261 in 1999.¹⁹ The amount of tariffs also significantly decreased during this period. In addition, as part of WTO accession, the PRC further reduced average import tariffs from 15.3% to 12% on more than 500 dutiable items and is committed to reduce tariffs on more than 5,300 commodities to 11% in early 2003 (ADB 2003).

c. WTO Accession

The year 2001 marked the PRC's entry to WTO. On 21 February 2002, the State Council issued revised provisional regulations on guiding foreign investment (Order 346). On 12 March 2002, the Government approved new foreign investment guidelines to allow wider foreign investment opportunities. These guidelines became effective on 1 April 2002.²⁰ The number of industries open to foreign investors increased from 186 to 262 and the number of industries where restrictions apply was reduced to 75 from 112.

The new *Catalogue for Sectoral Guidance of Foreign Investment* expanded the number of sectors where FDI is "encouraged," and reduced the number of "restricted" and "prohibited" sectors. Areas where FDI is encouraged include new agricultural technology and comprehensive agricultural development, energy, transportation, new material industry, and energy-saving and environment-friendly technology and equipment. The new guidelines also encourage and permit investments by wholly foreign-owned enterprises in some new sectors, such as exploration of natural resources, but only in the central and western regions. Foreign-invested projects for encouraged investment categories will be subject to less stringent legal and administrative requirements. Also, the new guidelines reflect specific sectoral opening requirements set by the PRC's WTO accession protocol (Appendix 4). Under the guidelines, foreign investment in broadcasting, utilities, and weapons production is still prohibited.

Entry into WTO requires the PRC to amend existing laws, regulations, and administrative practices and adopt new laws and regulations to comply with WTO rules and obligations (Box 3). The Government is committed to making necessary changes in laws and regulations that include codifying existing administrative practices into written laws and regulations to increase predictability and transparency. Intense efforts are being made to revise laws and regulations on trade, technology transfer, investments, banking, insurance, securities, taxation, customs, intellectual property, telecommunications, health, professional services, and other subjects to bring them into compliance with the WTO regime. As of September 2002, at least 2,300 government regulations have been reviewed and either amended or repealed by more than 30 government agencies (China Law and Practice 2003e and ADB 2001h). The Government's announcement that if there is a conflict between domestic laws and

¹⁹ Elena Ianchovichina citing personal communication with Nicholas Lardy.

²⁰ The full Chinese text of the official new catalogue is accessible at State Development Reform Commission's (SDRC) web site, <http://www.sdpc.gov.cn>. Please see Appendix 4 for an unofficial translation.

WTO obligations, the latter will rule, is an indication of the Government's commitment to adapt to the WTO rules-based regime. However, notwithstanding the PRC's WTO accession, most of the preferential policies for foreign-funded companies continue to remain in effect.

Box 3:

Highlights of the PRC's WTO Commitments

The PRC's WTO commitments accession are many and complex, covering such areas as tariffs, quotas, export subsidies, agricultural trade, telecommunications, banking, insurance, and other sectors and issues. The following is a summary of the more important commitments.

Tariffs, Export Subsidies, and Quotas

- The PRC will cut its average import tariff for agricultural products from 13% to 14% by 2004 based on a tariff-cum-quota system with import quotas increasing over time.
- The average tariff on industrial products will be cut from 18.5% to 9.4% by 2005, with tariffs on automobile imports cut from the current 80–100% range to 25%, tariffs on information technology products such as computers, semiconductors, and Internet-related equipment reduced from an average of 13.3% to zero, and tariffs on products such as wood, paper, chemicals, and medical equipment reduced to 7% by 2003.
- The PRC will eliminate export subsidies, quotas, and quantitative restrictions on imports within 5 years of joining WTO.

Telecommunications

- The PRC will phase out all geographic restrictions on paging and value-added services within 2 years of joining WTO, on mobile/cellular services in 5 years, and domestic wire line services within 6 years.
- The PRC will allow 49% investment by foreign telecom service providers from the date of accession to WTO, 50% foreign ownership for value-added services within 2 years of joining, and 50% foreign ownership for paging services within 3 years.

Banking

- The PRC will allow full market access to foreign banks within 5 years of joining WTO.
- Foreign banks will be allowed to conduct local currency business with PRC enterprises 2 years after WTO accession, and will be allowed to conduct local currency business with individuals after 5 years.
- Foreign banks will have the same rights (national treatment) as PRC banks.
- The current geographic restrictions on foreign bank operations will be removed within 5 years of joining the WTO.

(continued next page)

d. New Ministry of Commerce

At the 10th NPC, a decision was made to establish a Ministry of Commerce (MOC) by incorporating the domestic and foreign trade administrations of MOFTEC and SETC. The role of the MOC includes regulation and administration of foreign and domestic trade (equal treatment, level playing field), formulation of reform programs for the retail and distribution sectors, and formulation of foreign investment policies.

Box 3: (continued)

Insurance

- The PRC will permit foreign property and casualty firms to insure large-scale risks nationwide immediately upon accession, and will eliminate all geographic limitations for future licenses over 5 years, allowing access to key cities of priority US interest in 2–3 years.
- The PRC will expand the scope of activities for foreign insurers to include group health and pension lines of insurance, which represent about 85% of total premiums, phased in over 5 years after joining WTO.
- The PRC will allow 50% foreign ownership and remove JV requirements on foreign life insurers, and phase out internal branching restrictions.
- For nonlife insurance, the PRC will allow 51% foreign ownership upon WTO accession.
- The PRC will award licenses for insurance business based solely on prudential criteria, with no economic needs test or quantitative limits on the number of licenses issued.

Other Commitments

- The PRC has provided a broad range of commitments to open up the country's professional services, including legal, accountancy, taxation, management consultancy, architecture, engineering, urban planning, medical and dental, and computer-related services.
- The PRC will allow unrestricted access to the market for hotel operations with the provision to set up 100% foreign-owned hotels within 3 years of joining WTO, with majority ownership allowed upon accession.
- The PRC will allow trading rights (the right to import and export) and distribution rights for foreign firms, in areas such as wholesale and retail trade, after-sale service, repair, and maintenance.
- The PRC will allow imports of motion pictures and 49% foreign ownership in JVs involved in distributing motion pictures.
- The PRC will ensure that SOEs will make purchases and sales based solely on commercial considerations, such as price, quality, availability, and marketability; and provide foreign firms with the opportunity to compete for sales and purchases on nondiscriminatory terms and conditions.
- The PRC will allow foreign nonbanking firms to provide auto financing.
- The PRC has agreed to US safeguards remaining in place for another 12 years after WTO accession to prevent a sudden surge in imports damaging US producers. It also agreed to let the US maintain its current method of evaluating whether the PRC's goods were being dumped on the US market for 15 years.

e. Government Procurement

The Government, with ADB assistance, recently adopted new laws and regulations to expand opportunities for investors and promote competition in the PRC government procurement market.²¹ This rapidly growing market was expected to have reached \$12 billion in 2002. Multinational procurement groups have begun paying closer attention to this market and moving their sourcing to the mainland (Business Alert China 2002).

²¹ Pursuant to ADB's *Technical Assistance to the PRC for Formulation of the Government Procurement Law*, ADB helped the Government draft and adopt a unified, comprehensive national framework for government procurement. In ADB's *Technical Assistance to the PRC for Implementation of Tendering and Bidding Law and Related Regulations*, ADB helped the Government prepare implementing regulations under this law; develop and implement a campaign to disseminate the new requirements to the national, provincial, and local governments; establish an independent oversight agency; and train personnel to implement and administer the regulations.

The PRC began its first trial of government procurement in 1996, which developed quickly. In 2001, regional agents or centers of government procurement for goods, construction, and services emerged throughout the PRC, with total procurement volume reaching CNY65.3 billion (\$7.9 billion), more than doubling the previous year (People's Daily 2002a). To promote transparency and provide national standards and practices for the purchase of goods, construction works and services by government and quasi-government entities, the Government Procurement Law (GPL) was adopted on 29 June 2002 and became effective on 1 January 2003.²² Bidding for such contracts is subject to the 1999 Bidding Law (ADB 2000c).

Although adopting the GPL will provide opportunities for the private sector, further refinement is needed to ensure that SMEs and foreign suppliers will be able to participate. For example, under the GPL, priority is given to purchases of local goods, construction works and services, and every supplier, even where a consortium is entered into, is required to meet specific requirements to participate in government procurement bidding, including the professional and technical competence to perform government procurement contracts and a good record in paying local tax and social security contributions.

7. Labor

a. Mobility

Government policies regarding labor mobility (the *hukou* registration system) have been modified to reflect migration of a large number of rural workers to urban areas (Wing Cham and Li Zhang 1999). However, the system remains essentially unchanged and continues to impede the mobility of skilled labor and management.

The hukou registration system, which was formalized as a permanent system in 1958 to prevent wide scale urban migration, divides the PRC into rural and urban areas. The designation of a person's hukou registration place and status is inherited from his mother. Each citizen is required to register the place of regular residence in an urban center or rural settlement. Registration defines a person's rights for social and economic activities in a particular location.

Job eligibility may be limited to local hukou holders. Change of hukou registration and status requires government approval, which is not easily granted in the case of rural-urban migration. One needs to apply for both a permit to move and a migration certificate issued by the police in the places of designation and origin. The hukou registration authority will check up on the situation, the number of people moving, the reasons for the move, the time of the moving, their origin or destination, etc. (Wing Cham and Li Zhang 1999). The change in status is also subject to policy and quota controls. Persons who are recruited by the State or admitted by high education institutes are automatically entitled to migrate if such recruitment or admission requires migration.

Although the decision on whether to grant approval generally rests with the Ministry of Public Security (MPS), various government departments also have such prerogative. While hukou regulations state the procedures for migration, they do not specify the qualifications for migration. Different types of migration require different qualifications and documents that are decided by various government departments.

Formal migration from rural to urban areas is strictly controlled but flows in the opposite direction are allowed. Urban residents are allowed to move between cities but migration from small to big cities such as Shanghai and Beijing are more strictly controlled.

A series of measures was introduced in 1985 by MPS to address challenges raised by current increases in mobility. A system for administration of temporary residences (more than 3 months but less than 1 year subject to renewal) was organized for persons with short-term stays and without local regular hukou.

²² Procurement by the military and SOEs is excluded.

A new “blue-stamp” urban hukou was launched in 1992. This hukou permit is open to a wider population and includes more cities and towns, including large cities and special economic zones. Eligibility is primarily based on the assessed contributions to the urban economy. Eligible people include relatives of overseas PRC nationals; Hong Kong, China; or Macau, China investors, management, and technical staff who are employed by investors; relatives of overseas PRC nationals, Hong Kong, China; Macao, China; and Taipei, China compatriots who, with permission, purchase or build urban housing with foreign currency; persons who, with permission, purchase urban housing at market prices or build urban housing with their own capital; professionals and technical staff who work in developing areas; and other persons who make significant contributions to the urban economy. The new system helps legalize a part of the de facto urban population without committing central financial obligation and is administered by local governments who are given the flexibility to address their own needs. Applicants, in addition to having the means to live in urban areas where they intend to move, are required to pay fees for urban infrastructural construction. Blue stamp urban hukou holders are required to resume their original hukou status when moving out of the registered urban areas and are not considered as having gone through the process of changing their registration in the eyes of the Central Government.

In 1997, the State Council approved a policy document by MPS allowing 450 pilot towns and cities to grant urban hukou status for qualified rural hukou holders. Provincial governments are allowed to select some small cities and towns with a higher level of economic and infrastructural development with financial success for a 2-year experiment. Rural hukou holders who have stable nonagricultural jobs or stable living support and regular accommodations in selected towns and cities may apply for regular urban hukou after residing there for more than 2 years, but if approved will need to give up their use and right of land in the countryside. Successful applicants will then have the same right as those regular urban residents in respect to education, employment, subsidized foodstuffs, and social security and welfare benefits in the specified town or city. In contrast to blue stamp urban hukou, qualified applicants to this scheme do not have to pay a fee to the local government. Since regular urban residents still receive state subsidized welfare, the number of urban hukou holders under this program is subject to quota control that is set by planning departments in cooperation with related bureaucracies. This program increases the fiscal burden on local governments and directly competes with the blue stamp urban hukou program, which has resulted in income for local governments.

b. Unemployment

The concept of unemployment was unknown in the PRC until 1994 when SOEs began to lay off workers. As of 2001, the PRC had 20.8% of the world’s population and 25.6% of the world’s workforce (approximately 763 million people) (World Bank 2003). Although the size of this workforce gives the PRC a competitive advantage in providing cheap labor force, the increasing number of unemployed former SOE and TVE workers, number of rural surplus workers, the projected number of new entrants into the labor force, and problems in adequately funding social security, place increased pressures on the Government for a comprehensive solution.

It is difficult to gauge the number of unemployed workers in the PRC with any degree of accuracy. Unemployment statistics in the PRC only measure urban employment and do not take into account surplus rural workers who are limited by the hukou registration system from migrating into urban areas. Estimates of urban unemployment range between 8 and 9% (Jianjung 2002). The unemployment rate is much higher in the industrial rust belts in the North (Forney 2002), averaging at least 20%. Women have suffered disproportionately. Between 1995 and 2000, the number of urban female employees declined by more than 25% (Beijing Review 2003b). In addition, there appears to be at least 150 million surplus and idle workers in rural areas.

Unemployment has continued to rise notwithstanding steady GDP growth. During 1996–2000, with every percentage point of economic growth, the number of unemployed persons in urban areas grew by 520,000 (Asia Times 2002). Based on different economic assumptions (all

based on continued economic growth), in the next decade the PRC needs to generate between 90 and 300 million new jobs to redeploy people from agriculture, SOEs, TVEs, and for new labor market entrants (Section I.B.1.d. Employment).

Helping the increasing number of laid-off workers and unemployed people find jobs is a crucial and pressing task facing the Government (China Daily 2002c, People's Daily 2002b), which, instead of direct intervention, has increasingly focused on the adoption of policies that support the hiring of laid-off workers; increased employment opportunities through promotion of SMEs, PSD and investment; development of labor-intensive industries; encouragement of training programs to retrain laid-off workers; and job aid for the unemployed with special difficulties. The Government's role has increasingly focused on the need to readjust its employment policy if the economy loses pace and unemployment mounts.

8. Land Use

All land in the PRC is owned by the State or a unit of the local government. In rural areas, most land is collectively owned and the rights belong to a local government unit. However, relevant laws do not clarify which unit of local government is the legal owner.

In 1988, the PRC amended its Constitution and Land Administration Law to permit the transfer of "land use rights" to private persons and entities. There are two types of land use rights under the law: allocated rights and granted rights. Allocated rights are indefinite usage rights subject to expropriation with limitations on leasing, mortgage, and other terms of transfer. Granted rights allow land to be used for a fixed period that may be extended with government approval. Granted rights may be leased, mortgaged, and transferred.

The State Land Administration has adopted rules to provide for a uniform system of registering interests in land. Land use rights on state-owned land and agricultural collective owned land are required to be registered. Other real estate interests, such as mortgages and leaseholds on land use rights, and building ownership, must also be registered. However, determining the rights to land may be difficult. In general, there are multiple registry offices with uncoordinated records,²³ land registry records are often incomplete, and rules do not indicate where or how required notice should be published. Although land registry offices in major cities appear to be efficient, outside these cities, land registry offices may not have opened, or be consistently staffed or sufficiently equipped. It may also be difficult to obtain access to registration records.

The registry office prepares both a registration card that is maintained in the registry office and a registration certificate that is given to the transferee. The card, not the certificate, constitutes the official registration and legal basis of the title. In addition, the PRC does not have a universal survey system. Property descriptions often use monuments such as local roads, buildings or other features as beginning points for descriptions of land. When land descriptions are inadequate, interest in the same land may be registered under different land descriptions (Palomar 2002).

9. Price Liberalization

Prices have been liberalized throughout the economy except for energy and other utility prices. Currently, more than 90% of retail prices are determined by the market and competition in producer and consumer products in the PRC is intense (Organisation for Economic Co-operation and Development [OECD] 2002).

²³ In Beijing, Shanghai, Shenzhen, and other business centers, registration records for buildings and land are maintained together.

10. Exchange Convertibility

Although the PRC Government controls foreign exchange capital account transactions, policies regarding current account transactions have been liberalized over the last 20 years as foreign exchange reserves have increased. The State Administration of Foreign Exchange (SAFE), under the authority of PBOC, oversees foreign exchange controls. Under existing regulations, unless otherwise approved by SAFE or exempted under relevant regulations, domestic enterprises operating in the PRC are required to price their goods and services in the PRC in yuan. Foreign exchange received by such enterprise in current account transactions, except for amounts approved by SAFE, are required to be sold to authorized foreign exchange banks in the PRC. Domestic enterprises may, subject to applicable regulations, purchase foreign currency from authorized foreign exchange banks only after they provide documents evidencing a current account payment obligation.

Foreign exchange received by a domestic enterprise in a capital account transaction from a foreign bank is required to be deposited in foreign exchange with an authorized foreign exchange bank in the PRC and may be converted to yuan only with the approval of SAFE. To satisfy foreign currency requirements for settling of capital account transactions, domestic enterprises are required to obtain the approval of SAFE before purchasing foreign currency from authorized foreign exchange banks.

Since 1994, FIEs have enjoyed liberal access to foreign exchange (American Embassy in the PRC 2002). Subsequent growth in foreign exchange reserves, which exceeded \$475 billion as of the end of the first quarter of 2001, led to the SAFE decision to relax foreign exchange controls on both capital account and current account items (American Embassy in the PRC 2002).

FIEs are required to maintain a foreign exchange account for current account transactions pursuant to SAFE requirements. These requirements include SAFE permission to open the account, limitations on the amount of foreign exchange that can be held, and conversion of any excess foreign exchange into local currency.

The process for converting capital funds held in foreign currency by FIEs was simplified by the SAFE Circular on Reforming the Regulation of the Settlement of Foreign Invested Capital Funds that came into effect on 1 July 2002. This circular represents a policy shift in foreign exchange control from direct control by SAFE of FIEs to indirect control through authorized foreign exchange banks. Prior to this circular, foreign exchange laws required an FIE to first obtain SAFE approval to convert capital funds brought into the PRC from foreign currency into local currency, which took time. Under this circular, SAFE approval is no longer required if the FIE converts funds in a capital funds account opened with an authorized foreign bank.

B. RULE OF LAW

The transition from a command economy to a market-oriented economy makes legal rules matter. Direct government control over economic decisions is replaced by the rule of law that is necessary to protect private property and contract rights (World Bank 1997, IFC 2000b).

The rule of law is generally defined as (i) general, abstract rules that are prospective, never retrospective, in their effect; (ii) rules that are known and certain; (iii) rules that are equal in that they do not discriminate based on irrelevant distinctions; and (iv) a separation between regulators and the regulated (IFC 2000b). The rule of law in the business environment is expected to guarantee transparency, predictability, and consistency.

The PRC demonstrated its commitment to the rule of law by including the principle of “governing the country according to law” in the 1982 Constitution. Article 5 states that “all state organs, the armed forces, all political parties and public organizations, and all enterprises and

institutions must abide by the Constitution and the law. All acts in violation of the law must be investigated.” The Constitution also states that “no organization or individual is privileged to be beyond the Constitution or the law.” These provisions are clear and self-explanatory (ADB 2002c).

In 1997, the 15th Communist Party Congress explicitly cited the rule of law as a guiding principle in an official document and proposed to create a comprehensive framework with Chinese Characteristics by 2010 (Zhenmin 2002). The 1999 Constitutional Amendment upgraded the status of the private sector from a “supplement” to public ownership to an important component of the socialist market economy and guaranteed legal protection of private property rights.

Although the PRC’s legal system is a mix of common law and the continental legal system (German civil law system model) with less emphasis on legal precedent, it differs fundamentally from western law in many reports. For example, in practice, it lacks an independent judiciary.

Prior to economic reforms, economic laws were scarce. Since 1979, the volume of legislation and regulation has grown rapidly. Commercial laws began to develop in the 1980s and accelerated in the 1990s. From 1979 to mid-2000, the Central Government promulgated 311 new pieces of legislation, 700 sets of regulations, and over 4,000 administrative rules. In 2001, NPC and its Standing Committee passed 23 major laws. From 1980 to mid-1999, provincial governments approved 7,448 local laws and regulations, many of which affect the private sector (ADB 2002c).

Laws and regulations promulgated by NPC override local provincial laws. While NPC can issue overriding legislation, often such legislation is in the form of general principles and guidelines that permit broad interpretation. Implementing regulations by government agencies and local government officials clarify these laws but are often inconsistent. In addition, these regulations often include inconsistent interpretations (ADB 2002c).

The PRC’s entry to WTO has accelerated the process of adapting the country’s legal system. As a result of the PRC’s entry to WTO, approximately 2,200 laws and regulations need to be modified or repealed (Section II.A.6.c. WTO Accession).

C. INSTITUTIONAL FRAMEWORK

The institutional framework for a modern enterprise economy in the PRC is not fully in place. As discussed above, property rights are difficult to establish and corporate governance reforms are difficult to implement based upon state control of most listed companies and market institutions (Section IV.A.2.a. Capital Markets). A majority of SOEs and local governments do not have the skills needed to restructure business, implement new governance structures, manage the transfer of social benefits, or reschedule debts, making it difficult to effectively implement the policy environment for SOE reform. Although the Government appears committed to separating ownership from operational control, key managers continue to be appointed by government officials.

The economy is managed by the central and provincial governments and new regulatory agencies. Executive power is centralized in the State Council, which governs and regulates almost all economic activities and administrative issues in the PRC. The 10th NPC held in March 2003, which included 65 private sector representatives, approved the restructuring of the government to, among others, reflect the increasingly important role of the private sector in the economy. New ministry-level agencies under the State Council were formed. The State Development Planning Commission (SDPC) was reorganized as the new State Development and Reform Commission and is expected to improve macroeconomic control. A new MOC was created to promote the reform of domestic and foreign trade and commerce and exercise the powers of SETC and MOFTEC, both of which were abolished. A new SASAC was established to take over the daily management of SOEs (Section II.A.3. Ambiguous Private Property Rights). The China Banking Regulatory Commission (CBRC) was also established to take over the banking regulatory role

from PBOC, which will now be primarily responsible for monetary policy.²⁴ MOF continues to have primary responsibility for developing and implementing policy in areas including banking, social security (e.g., pension funds), and the government debt market. It is also responsible for development of national accounting standards and acts as the issuing agent for treasury bills and government bonds.

As per the reorganization, key economic sectors are now regulated by the following bodies:

- (i) Banking and Finance: PBOC, CBRC, MOF;
- (ii) Insurance: China Insurance Regulatory Commission (CIRC);
- (iii) Securities Markets: CSRC;
- (iv) Competition and Consumer Protection: Various bodies enforce commercial laws relating to competition and consumer protection, including SAIC; and
- (v) Public Utilities: the newly established State Electricity Regulatory Commission (SERC) is responsible for supervising electric power while the Ministry of Construction supervises the management of water and sewerage.²⁵

Regulatory bodies may not be fully funded from the national budget and may exist at the central level and/or at the local level. Central-level bodies are more responsible for policy making while local-level bodies are more responsible for enforcement. Local-level bodies may be part of local government and responsible to local officials who may control funding and personnel. Recently, public pressure placed a draft Law on Supervision of Administrative and Judicial Bodies high on the NPC's agenda. This draft law provides additional powers to People's Congress members at the national and local levels to supervise the functions of administrative and judicial government bodies (China Daily 2002f).

Since the late 1980s, the Government has corporatized some government departments that sell goods in market (e.g., the Ministry of Petroleum became the National Petroleum Corporation in 1988, the Ministry of Electric Power became the State Power Corporation in 1997).

Public sector employees number about 125 million (World Bank 2002b). Approximately 88 million public sector employees work in SOEs and 37 million are employed directly or indirectly in the government. Civil servants are recruited competitively and selection is based on examinations. Relevant regulations require them to be promoted on the basis of their ability and political integrity and rewarded according to performance. Civil servants are supposed to be compensated in line with remuneration received by SOE managers with the same level of responsibility. Notwithstanding, the gap between the compensation for civil servants and those in the private sector is substantial, especially in developed areas.

Reforms in the civil service have resulted in a dramatic increase in the education levels of leading PRC officials, although less than half of the civil service has graduated from university. Better-educated and younger officers have improved bureaucratic capacity (ADB 2002c). For example, younger and more qualified officials now staff key regulatory agencies such as the CSRC where, in 2001, 86% of employees had university or postgraduate degrees.

²⁴ The restructuring of the Government is ongoing and the role of new government agencies is still being clarified and discussed. Thus, this private sector assessment (PSA) continues to refer to the names of government agencies that have been abolished with respect to the adoption of key policies and regulations that impact private sector development.

²⁵ See footnote 85 regarding the establishment of SERC.

D. NONGOVERNMENT ORGANIZATIONS

Government policy does not encourage the development of nongovernment organizations (NGOs) (ADB 2002c, Far Eastern Economic Review 2002b). Indigenous NGOs are required to have a government department as their sponsor. In practice, most NGOs find few government departments willing to accept such a responsibility. The Government bars the registration of more than one NGO in a particular field in each region. NGOs are not allowed to set up regional branches and unless permission is granted, they cannot operate outside of the district where they are registered. Foreign NGOs are not allowed to register.

Box 4:

The All China Federation of Industry and Commerce

The All China Federation of Industry and Commerce (ACFIC) was founded in 1953 as a quasi-NGO and primarily serves as a bridge from the Party and the Government to industrial and commercial enterprises in the PRC, although it also provides other services to promote its members' economic interests. ACFIC is empowered to nominate members to the Chinese People's Political Consultative Conference (CPPCC) and National People's Congress (NPC), propose bills to NPC to promote the interest of its members, and liaise with government officials on politics and regulations affecting non-public business development. ACFIC recommends 60 delegates annually to NPC and 65 to CPPCC (every 5 years when they change terms) from its membership. Because of its participation in national legislative bodies, some senior officials of ACFIC may view it as a lawmaking body rather than a lobby for its membership. Some private entrepreneurs join a local chapter of ACFIC so that they can be nominated to the CPPCC and NPC.

ACFIC is empowered to (i) organize economic events such as trade fairs, exhibitions, technology exchanges, and other networking events; (ii) promote foreign economic and technological cooperation and trade, and support linkages between the PRC and foreign companies; and (iii) disseminate information on government policies, markets, new technology, and many other things.

Recently, ACFIC played a role in establishing the first nonstate-owned bank in the PRC, Minsheng Bank, as an advisor to the Government. The Chairperson of ACFIC is on Board of Minsheng Bank. ACFIC, through its chapters, conducts an annual survey of large enterprises, which reports on enterprise structure, operations, employment, and sales. It has also been involved in advising the Government on credit guarantee schemes (CGSs) to promote lending to small and medium enterprises (SMEs). However, in general, the Government directs ACFIC in what services it should provide.

As of 30 September 2001, ACFIC had 1.57 million members, of which 233,499 (13%) were private firms, although firms under various forms of nonstate ownership comprise 83% of membership. All sectors are represented. Most members are SMEs and individually owned enterprises (*geti hu*). ACFIC has 3,059 local chapters at the country level and above, of which 358 local chapters are located in major cities throughout the PRC, covering 95% of the nation's administrative regions. There are 18,581 chapters at the town and community levels, 461 of which were founded in 2001, and all of which are fee-based. The relationship of chambers at various levels is informal. There is no financial and/or administrative link between different chamber levels. Each chamber is independent and supported by its respective local government, which provides it with budgetary support. There is considerable variation in the organizational structure, size, and activities of different chambers depending on the local conditions and attitudes of local governments. The range of services provided by individual chapters varies considerably based on the regional situation, membership needs, and local government guidance. For example, chapters in the South seem greatly influenced by the example of the Hong Kong, China Chamber of Commerce, which operates more like the business-focused chambers of developed countries. ACFIC also has loose links with other organizations that have responsibilities for private enterprises or exist to provide services to them.

ACFIC employs 166 staff members, of which half occupy management positions. Staff are well educated and experienced. The entire ACFIC system employs more than 100,000 persons. ACFIC's revenues are comprised of an annual government appropriation and the fees collected for organizing events for members. Funding estimates for the vast ACFIC system may be more than CNY1 billion annually. ADB recently provided technical assistance to ACFIC to, among others, help it reassess its role in the transitional market economy and develop a future strategy focusing more on member services and less on its traditional political function.

Source: ADB. 2000. *Technical Assistance to the PRC for Private Sector Development*. Manila.