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CHINA AND THE OECD

- **Economic Survey of China**
- **China's Governance in Transition**
- **Agricultural Policy Reform in China**
- **Attracting Investment to China**

Economic Survey of China, 2005

Why has growth been so rapid?

How could growth prospects be further boosted?

How to ensure a stable macroeconomic environment?

What reforms should be made to the financial system?

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Introduction

China's economic growth has averaged 9½ per cent over the past two decades. The rapid pace of economic change is likely to be sustained for some time. These gains have contributed not only to higher personal incomes, but also to a significant reduction in poverty. At the same time, the economy has become substantially integrated with the world economy. A large part of these gains have come through profound shifts in government policies. Reforms have allowed market prices and private investors to play a significant role in production and trade.

Further notable challenges remain: to provide a firm framework for private sector activity; to maintain a stable macroeconomic environment; to reform the financial system; to reduce regional inequalities by reforming fiscal transfers.

The private sector is driving growth and can be strengthened further

The scope of private ownership has become substantial, producing well over half of GDP and an overwhelming share of exports. Private companies generate most new jobs and are improving the productivity and profitability of the whole economy. The government has restructured the state-owned business sector, resulting in a massive loss of jobs. Still, a large part of the state sector remains to be restructured; policies to facilitate this process have been identified and are being expanded. The performance of the business sector could be strengthened more through a further modernisation of the business framework and better enforcement of laws in the economic sphere, especially those for intellectual property rights.

A more flexible exchange rate would support a stable macroeconomic environment

While fiscal policy has been run in a stabilising fashion, the outcome of monetary policy has been considerable volatility of inflation. Greater flexibility of the exchange rate would allow the authorities to guard against any further increase in inflation in both product and asset markets, more easily adapt monetary policy to domestic concerns, and allow market forces to

This policy brief presents the assessment and recommendations of the 2005 OECD Economic Survey of China. A draft of this Survey was prepared by the Economics Department. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, held a special seminar to discuss this survey with the participation of the Chinese government. It was revised following the discussions in this seminar, and is issued under the reponsibility of the Secretary-General.

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determine bank interest rates to a greater extent. The change in the exchange rate arrangements announced in July 2005 is a step in that direction.

Further reforms are needed in the financial sector

Until five years ago, lending policies led to the accumulation of a considerable quantity of bad loans. The recapitalisation of more than two-thirds of the banking system to eliminate this historical burden is almost complete and the cost to public finances of completing the exercise, while substantial, appears to be manageable. Wide-ranging reforms have improved the capacity of banks to make market-based lending decisions. Overall, these policies appear to have been successful, as new loans have been of much higher quality, even using the new, more realistic, classification system for non-performing loans. Further progress will require a continued focus on improving governance and increasing private ownership. Policies designed to expand and further deregulate capital markets would improve the allocation of capital, lower the risk of further waste of savings, and minimise systemic risk.

Solid public finances could permit tax and expenditure reforms

Rapid growth of revenues and control of expenditure has put public finances in a sound position. As a result there is scope to move towards less discriminatory taxation of different types of companies and activities, while maintaining low marginal tax rates. Expenditure on health and education both in rural areas and for migrants in urban areas could also be strengthened, but achieving this objective may require an overhaul of fiscal relations between different levels of governments. Such spending would help reduce inequalities but would need to be complemented by further labour market reforms. Additional reductions on the restraints to migration would help to facilitate a more rapid pace of urbanisation that could help to reduce income inequalities, especially if public services are guaranteed to newcomers and if those who leave rural areas do not lose their land-use rights. Increased urbanisation would need to be accompanied by policies designed to lower the high level of pollution in an efficient, economic fashion. ■

Why has growth been so rapid?

The pace of economic change in China has been extremely rapid since the start of economic reforms just over 25 years ago. Economic growth has averaged 9½ per cent over the past two decades and seems likely to continue at that pace for some time. Such an increase in output represents one of the most sustained and rapid economic transformations seen in the world economy in the past 50 years. It has delivered higher incomes and a substantial reduction of those living in absolute poverty. The size of the economy, when measured at market prices, now exceeds that of a number of major European economies and may be exceeded by only three OECD member countries in five years' time. While average incomes are still below those in other middle income countries, there are large parts of the country that have reached the income levels seen in some developed East Asian countries just one generation ago and are proceeding along a similar rapid catch-up path. Many industries have become completely integrated into the world supply chain and, on current trends, China could become the largest exporter in the world by the beginning of the next decade. Underlying this growth there has been a profound evolution of economic policies that has transformed the efficiency of enterprises.

This extraordinary economic performance has been driven by changes in government economic policy that have progressively given greater rein to market forces. The transformation started in the agricultural sector more than two decades ago and was extended progressively to industry and large parts of the service sector, so that price regulation was essentially dismantled by 2000. While price controls were being abolished, the government introduced a pioneering company law that for the first time permitted private individuals to own limited liability corporations. The government also rigorously enforced a number of competition laws in order to unify the internal market, while the business environment was further sharpened by allowing foreign direct investment in the country, reducing tariffs, abolishing the state export trading monopoly and ending multiple exchange rates. The momentum towards a freer economy has continued this decade with membership of the World Trade Organisation resulting in the standardisation of a large number of its laws and regulations and the prospect of further tariff reductions. In addition, fundamental changes were made to the constitution in 2004, stressing the role of the non-state sector in supporting economic activity in the country and protecting private property from arbitrary seizure. In 2005, regulations that prevented privately-owned companies entering a number of sectors of the economy, such as infrastructure, public utilities and financial services were abolished. Overall, these changes have permitted the emergence of a powerful private sector in the economy.

The government has also introduced wide ranging reforms into the state-owned sector that dominated the economy in the early 1990s. State-owned enterprises have been transformed into corporations with a formal legal business structure and many have been listed on stock exchanges that were created in the early 1990s. Since 1998, a policy of letting small enterprises go and restructuring large companies has been successfully pursued, with the number of state-controlled industrial enterprises falling by over one half in the following five years. Employment contracts were made more flexible, leading to job reductions in the industrial sector of over 14 million in the five years to 2003. This process was aided by the creation of unemployment and welfare programmes that transferred the burden of compensating redundant workers from enterprises to the state. Finally, in 2003, the government rationalised its control over state-controlled enterprises further by creating an agency charged with exercising the government's ownership rights and boosting the performance of these enterprises.

These reforms have improved the framework for mobilising the resources generated by one of the highest rates of savings in any economy – the gross saving rate approaches half of GDP – generating a particularly rapid increase in the capital stock, although such estimates can only be approximate since there are no official estimates either of the capital stock or of constant price estimates of expenditure components of GDP, the absence of which complicates interpretation of economic trends. Investment has, in part, served to raise the assets available to each worker in the business sector, so boosting the annual growth of labour productivity to 8½ per cent in 2003. It has also been used to create an increasingly urban society – a movement that has gone in step with a flow of people from the land into the service and manufacturing sectors of the economy. Since workers in agriculture have low productivity, such a movement has boosted growth considerably.

In parallel with the growth of physical assets, the government has pursued a policy of raising the education qualifications of young people. It launched a programme to give all children nine years' education, moving recently to ensure that all rural areas achieve this goal by 2006. Higher education has also been transformed. In the five year period to 2003, the number of students joining higher education courses has risen by 3½ times, with a strong emphasis on technical subjects. As a result of these policy initiatives, the average quality of the labour force has also been improving significantly, with new entrants to the labour force having almost three times as many years of schooling as those who are retiring. Finally, government initiatives have freed the urban labour market, with the wages for educated staff being pushed up by the growing influence of a market economy.

Indeed, the changes in government polices have created a largely market-oriented economy in which the private sector plays a key role. Precise measurement of the size of the private sector is difficult, but a definition which considers as private all companies that are controlled neither by state nor collective shareholders suggests that the private sector was responsible for as much as 57% of the value-added produced by the non-farm business sector in 2003. Even amongst larger companies in the industrial sector, the private sector produced over half of value-added in 2003 and that share appears to have risen even further in the following two years. Overall, between 1998 and 2003, the progressive evolution in government policies allowed a fivefold rise in the output of domestically-owned private companies and a threefold rise in the output of non-mainland controlled companies; by contrast, the output of the state sector rose by just over 70% in this period.

The growth in private output has also been the result of the higher productivity of most companies in the sector. The sharper incentives facing the private sector companies have resulted in them using less capital and labour to produce output than state companies. Overall, the aggregate productivity of private companies in the industrial sector is estimated to be almost twice that of enterprises controlled directly by the state. The profitability of private companies has also risen considerably and, by 2003, they were earning a 15% rate of return on their physical assets. Such a high level of competitiveness has resulted in the private sector accounting for three-quarters of all exports in 2003. While the bulk of these exports are made by foreign-controlled companies, the domestically-owned private sector managed to quintuple its exports in the five years to 2003, as more small and medium sized enterprises were granted export licences. Overall, the growth in private sector ownership has had a very favourable impact on real incomes and macro-economic activity, boosting the level of multifactor productivity in the industrial sector by close to 10% in five years. With the decision in 2005 to allow private enterprises to establish businesses in many previously restricted areas, further improvement in multifactor productivity may be possible. ■

How could growth prospects be further boosted?

The growing importance of the private sector in supporting the economy makes it all the more important to further modernise the legal framework for business. The government is preparing legislation in three important areas: bankruptcy law, company law and the implementation of the constitutional amendment on property rights. The second draft of the bankruptcy law has now passed the legislature and is generally acknowledged to follow international best practice. The law should clearly establish the precise claims that employees have on assets, limiting payments to wages owing to employees and leaving other costs, such as redundancy and resettlement expenses, to social funds. Secured creditors would be more likely to lend to private companies under such circumstances. A new company law is under consideration. A reduction in the barriers to the formation of both limited and joint stock companies should be a priority. The upper limits on the number of shareholders in a limited company should be abolished, while at the lower end companies with one shareholder should be allowed. For both sorts of companies the minimum capital requirements needed for incorporation should be lowered. Such changes would facilitate the expansion of privately-owned companies. The revised company law should aim to improve corporate governance, notably offering better protection to minority shareholders in both quoted and unquoted public companies and defining the role of corporate bodies such as the supervisory board and the duties of directors. In addition, the proposed anti-monopoly law should cover a much wider range of anti-competitive activities than do current laws. Finally, rapid introduction of the laws to implement the constitutional amendment on private property rights should be envisaged.

Beyond the content of the law, though, there is a more substantial problem of giving force to economic laws. A relatively complete set of laws and regulations covering intellectual property rights is in force, having been updated in 2001. The focus of government policy in this area has now switched to the enforcement of these laws. Adequate protection of intellectual property is also of increasing importance to Chinese entrepreneurs. Weaknesses here may hold back the degree of innovation and product development of local companies. At present, in this and other areas, it can be very difficult to obtain judgements in court and even more difficult to obtain enforcement of the judgement. Such difficulties are not just felt by foreign enterprises. Chinese entrepreneurs feel that expansion across provincial borders is made difficult by the lack of objectivity of local judiciaries when it comes to trying cases involving the infringement of trade secrets, intellectual property rights and contract enforcement more generally. The solution would appear to require a series of steps. One might be to transfer some of the financing of courts to the central government; another would be increase the extent of specialisation of the courts (notably in the area of bankruptcy and intellectual property).

Reforms in the way that state-controlled firms are managed have improved performance but there remains significant scope for further improvement. In the industrial sector, the rate of return earned by state-controlled companies rose from 5% to 10% in the five years to 2003. Most of the increase in returns has, however, come from a minority of companies. Over 35% of all state-owned companies are not earning a positive rate of return and one in six has negative equity. For loss-making enterprises, the government has announced a four-year programme that will involve substantial additional restructuring. In some cases, asset sales may be possible in which case it is important to follow the regulations, issued in the spring of 2005, that ensure transparency in management buy-outs. Within this framework, assets need to be valued on a forward-looking basis, supplementing valuations based on the acquisition cost of assets. Greater use could be made of the new property exchanges to ensure competitive prices are achieved for state assets. The government could also consider further sales of packages of distressed assets to companies with experience of restructuring, in order to supplement the efforts of the asset management companies. For quoted state-controlled companies, which earn returns on assets comparable with those of listed companies worldwide, the government has announced that there will be a progressive lifting of the non-transferability of state and local government owned shares, an initiative that could ease mergers and acquisitions. ■

How to ensure a stable macroeconomic environment?

The growing importance of the private sector puts a premium on the maintenance of a stable macroeconomic environment – notably in the area of prices. Fiscal policy has been run in a stabilising fashion. The overall fiscal position is sound, and has allowed scope for counter-cyclical management: expenditure and deficits were allowed to expand in 1998, when external developments threatened to reduce the pace of economic expansion; and deficits were reduced, while expenditure was kept under control when revenues surged beyond budget expectations in 2004. Yet, the past decade has seen considerable volatility in the inflation rate, almost 8 times that in the United States and 4 times that in Western Europe. The annual rate of inflation, when measured by the GDP deflator, has moved from 6% in 1996, to slight deflation in 2002, before rebounding again in 2003 and 2004 and still registered a rate of 4¼% in the first half of 2005, though the consumer price index has slowed to a greater extent at the beginning of 2005 due to its high food content.

Such fluctuations suggest that domestic monetary policy has not always been successful in maintaining low and stable inflation. Rather, the existence of a relatively fixed rate of exchange against the dollar has exposed the economy to inflationary or deflationary impulses stemming from fluctuations in the effective exchange rate of the dollar. In the current cycle, the combination of a rising current account surplus and foreign direct investment inflows has led to a need to purchase dollar assets to stabilise the exchange rate. The Chinese authorities have been able to sterilise much of this inflow through changes in reserve ratios, open market operations and window guidance to restrain the growth of bank lending without raising interest rates. However, given that inflows amounted to 12½ per cent of GDP in 2004 and, in line with experience in other countries, central bank sales of securities may eventually disturb the portfolio balance of the private sector, putting upward pressure on interest rates. Although there are strict controls on capital inflows, there is a likelihood that, with increasing trade flows, the capital account may become increasingly porous and responsive to any such increase in interest rates, increasing the pressure for sterilisation. Moreover, reliance on window guidance to limit bank lending goes against the government's policy of increasing the use of market-based instruments to control monetary developments. Indeed, in line with this policy, the authorities have started to develop foreign exchange and derivative markets that would allow a redistribution of risks stemming from exchange rate fluctuations. Overall, a policy of allowing greater flexibility in the exchange rate would allow the authorities to guard against the risk of any further increase in inflation in both product and asset markets, to more easily adapt monetary policy to domestic concerns and to allow market forces to determine bank interest rates to a greater extent. The July 2005 revaluation for the currency, together with the associated change in the exchange rate arrangements, represents a step in this direction. ■

What reforms should be made to the financial system?

One concern of the authorities in moving to a more flexible exchange rate, perhaps overstated given the low exposure of banks to foreign lending, has been the weakness of the banking system, but significant reforms have now been undertaken in this area. Until 1995, banks paid considerable attention to national policies in determining the allocation of bank credit. As a result, banks accumulated around CNY 4 trillion of bad debts mostly as the result of loans made in the period up to 1999. Wide ranging reforms have been introduced since then. Banks have started to modernise their lending and risk management practices. Better risk weightings have been introduced by the banking regulator and the classification system for non-performing loans has been made more realistic. Foreign investors have been allowed to acquire stakes in 12 second-tier joint stock banks. Overall, these reforms appear to have been successful, as since 2000 the new loans made by banks seem to be of a much better quality. With a reform of the banking sector infrastructure in place, the government has embarked on a strategy of recapitalising the major banks and preparing to list them on the stock market. The process of establishing a sound banking system is now well advanced for two of the major banks and has started with a third.

Re-organisation of the remainder of the banking system is still needed and would be best accompanied by a growing marketisation of the banking sector. Almost 30% of the banking sector remains to be recapitalised. The process may take some time in the rural credit co-operative sector where there are a large number of small institutions with significant problems. Progress has been made in a number of pilot provinces where co-operatives have been converted into commercial banks. The companies set up to dispose of non-performing loans, previously owned by banks, are recovering about 20% of their face value and so eventually there will be a need for the government to provide for their refinancing. Taking this into account, the ultimate costs to the government budget of recapitalising the banks, though likely to be substantial, appear manageable. But recapitalisation only represents the first step in improving the banking system. Better governance is also needed. Amongst both the joint-stock banks and city commercial banks one possible route might be to involve the non-state sector to a greater extent than at the present, as there are only a couple of banks controlled by private interests, while limiting the participation of industrial and commercial groups. As to the major banks, policy should focus on improving governance; in particular by introducing a transparent recruitment process for appointments to senior management posts. Given that a move to private ownership and changes in management are likely to take time, the bank regulator will have a key role to play in ensuring that banks put adequate risk management tools into place.

Broadening financial markets is a further crucial aspect of improving the allocation of capital. At present, such markets have a limited role and this generates a concentration of financial risk in the banking sector to a greater extent than in OECD economies. The equity market could be further developed, as the market value of freely tradable shares represented just 9% of GDP in 2004. Moreover, nearly all the quoted companies are state-controlled, while outstanding corporate bonds were equivalent to less than 1% of GDP in 2003. Share markets are unable to act as a market for control as the bulk of issued shares have restrictive covenants that, in theory, limit their transfer. The government is moving in the direction of liberalising the market, by easing restrictions on the sale of state-owned shares in quoted companies. At the same time, the pricing of initial public offers has been put on a more market driven basis, but the final decisions on which companies are listed are still made by the State Council. A freer procedure could be considered subject only to ensuring that issuing criteria have been met and that information disclosure has been adequate. In the corporate bond market, decisions on new issues are still determined administratively and are subject to industrial policy criteria. Here too a more neutral procedure could be considered. Such reforms would allow the developing private sector greater access to capital markets and make the markets more efficient, so helping to avoid the significant waste of savings represented by non-performing bank loans. Moreover, improved financial returns would benefit those saving for retirement. ■

Will population ageing generate a fiscal deficit?

A greater role for capital markets is all the more important given the rapid ageing that will occur in the population over the next two decades. Since the nationwide reform of 1997, the public pension system, which only covers 14% of the active population, has been a two-part system. The first part provides a basic flat rate pension while the second part provides a pension proportional to contributions, revalued by the bank deposit rate. This second part could, eventually, be developed into a fully-funded individual account system, with the balances invested in capital market instruments that would yield more than bank deposits. A trial reform in this sense has been launched in several provinces. At present, all contributions are needed to pay existing pension entitlements and so the pilot programme requires transfers from government revenues to meet the transition costs. A generalisation of such trials would likely require a reduction in prospective pension outlays in order to fund these costs and so avoid fiscal deficits. This could be achieved by equalising and raising retirement ages for men and women, phasing out early retirement schemes and bringing benefits from the second part of the system into line with life expectancy at retirement. In addition, the government is committed, in principle, to using part of the proceeds from selling participations in state-owned companies to create a fund to smooth the spending of the pension system. Such a policy has considerable scope for raising funds given that state assets are equivalent to 80% of GDP. Over the longer term, consideration will need to be given to widening the coverage of the pension systems to rural areas as, with increasing migration, traditional support systems for the elderly may function less well. ■

Is there room for tax reforms?

Public finances are in good shape. The reform of public finances introduced in 1994 has permitted a strong rise in government revenues with a larger part coming from indirect taxation rather than from levies on income. The management and transparency of public finances has also been improved. These reforms have provided a strong basis for restoring public expenditure after the crisis of the first half of the 1990s that was linked to the fall in profitability of state-owned enterprises. Between 1994 and 2000, public expenditure rose by almost 7 percentage points of GDP but is still fully 13 percentage points below the OECD weighted average. Such a difference is mainly due to low payments for both social security and debt interest. Indeed, apart from these two areas, public spending absorbs a similar share of GDP as in the OECD area. More recently, rapid growth of revenues and tight control over expenditure has been used to bring the overall budget deficit down to below 1% of GDP and to keep public debt stable at around 23% of GDP.

If government revenues continue on the buoyant path of the past few years, a number of reforms could be considered with the objective of reducing distortions. One change already envisaged by the government is the equalisation of the rate of company taxation for domestically and foreign-owned companies. The basic rate of corporate income taxation, at 33%, is in the upper quartile of rates in the world. On the other hand, foreign companies are taxed at a rate (15%) that is amongst the lowest in the world. The unified rate will need to be set at a competitive level for firms in China in order to encourage domestic capital formation, suggesting a unified rate close to that currently paid by foreign companies. At the same time, dividends paid to domestic shareholders could be exempted from any further taxation, so bringing the tax rates on risk capital more into line with the tax on government bonds. The government is testing the deductibility of VAT on investment goods in a number of provinces. If this change is generalised, it will be important to ensure that there is no discrimination in the tax treatment of investment in different industries. At the same time, the base of VAT could be widened to include all services, with consequent changes made to the business tax.

Over the medium term, some changes could also be envisaged to personal income taxation. In this area, the system has been kept simple, with few deductions and a flat tax on income from capital. At present, few people have sufficiently high incomes to pay the highest marginal tax rate of 45% and the average marginal tax rate is low. But, given rapid growth in incomes, this situation could change if allowances and thresholds remain without any indexation to wages or prices, as has been the case since 1980. A strong signal of the intention of the government to continue its support for private sector entrepreneurial activity would be to reduce top marginal income tax rates, a move that would cost little in revenue but would align China with a number of other transition countries that have found that a low tax rate encourages the declaration of income and improves incentives for economic activity. At the same time, an increase in thresholds below which income tax is not paid would help preserve equity. ■

Should public expenditure be re-oriented?

There has been a marked recovery in public expenditure, particularly in the area of investment, in the past decade. Public outlays on education and health are low relative to OECD countries and moreover have tended to favour better off groups in society. On the other hand, in recent years, total government-financed capital outlays, including direct capital formation and investment financed by capital transfers, have, on a national accounts basis, amounted to over 9% of GDP and helped create, *inter alia*, a freeway system. However, there is evidence that some of this investment has been wasteful, suggesting that some re-orientation of spending may be needed. The government has started to increase health and education expenditure but a further effort will be needed, especially in the poorer parts of the country as outlays are still low relative to needs. Achieving such a result may require another overhaul of fiscal relations between different levels of government. The reform of the mid-1990s has allowed a major increase in transfers from central to sub-national government that has helped stabilise inequalities in public spending across the country. However, health and education expenditure is undertaken at the lower levels of government which have inadequate sources of tax revenue and are dependent on transfers whose importance varies considerably across the country. Greater attention needs to be paid to aligning the revenues of local government to their expenditure mandates and to designing an equity-oriented national scheme for sub-national fiscal relations. ■

Can differences in regional incomes be reduced?

Increased fiscal transfers have helped lessen some of the inequalities in economic development but need to be complemented by further liberalisation of the labour market. Since 1999, polices have been in place to boost infrastructure and education spending in the poorest, western areas of the country with the objective of providing the conditions for faster growth. Programmes are also in place to reduce taxation and illegal fees in rural areas, so boosting incomes. Such programmes could be usefully complemented by efforts to create a national, or at least provincial, labour market. At the moment, it is difficult for workers and their families to permanently change their place of residence. Even for a temporary move, many permits are required and many local services, such as education and health are either not available to migrants or only available on unfavourable terms. Moreover, if a rural person moves permanently to a city, his rural landholdings are forfeited without compensation. The government has been reducing restrictions on movement but further relaxations would tend to reduce rural-urban income differentials.

Migration will bring increased urbanisation that will need to be managed carefully. At present, Chinese cities are more equally sized than those in other economies. Considerable gains in productivity might be achieved with larger cities and recent government reports have highlighted the benefit of creating three major agglomeration hubs, as well as a number of city belts on the coast and major rivers. However, policies with regard to land ownership tend to militate for relatively extensive urban development, as cities and towns retain most of the funds from the sale of land leases, leading the central government to curb excessive development during the current upswing. Following extensive privatisation during the past decade, a residential housing market has emerged, with the owner occupation rate approaching 70% in urban areas. Nonetheless, the short length of commercial and residential leases (40 and 70 years, respectively) may constitute a barrier to effective improvement of land, as property on the land reverts to the state at the end of a lease. In 2003, new legislation gave farmers the right to a 30 year lease on their land, but this law has not yet been fully implemented. Moreover, leased land may be subject to redistribution when household size changes. Longer leases might improve incentives for rational land-use.

In sum, the very wide urban-rural income differences mean that large-scale migration will continue one way or another. On the positive side, continued urbanisation will contribute to growth, and also to reduced inequality. But managing the process is complex and requires simultaneous reform in several areas: reduction in regulated barriers to migration; land-law reforms to underpin a more efficient urbanisation process; changes in fiscal relations among levels of government (particularly within provinces) to assure an adequate funding of health and education spending for the newly urbanised population; as well as proper incentives for urban governments to allocate resources to these ends. ■

Can the quality of the environment be improved?

Increased urbanisation and economic activity has taken place in the context of an environment that is subject to a high level of pollution. Government policies have been successful in containing the level of pollution but, even so, five of the ten most polluted cities in the world are in China. Investments under the 9th and 10th five year plans have improved pollution control. Indeed, the quantity of sulphur emissions rose only 5% between 1993 and 2003, despite GDP more than doubling in the same period. The upswing in emissions in the recent business cycle suggests that it will be a significant challenge to ensure that environmental measures and energy policies are sufficiently forceful to lower pollution levels markedly. New legislation, introduced in 2003, has strengthened the use of economic instruments by markedly increasing penalties paid for the emission of air and water pollutants. As yet, though, few old power stations are fitted with anti-pollution equipment and the level of pollution, both for air and water, remains high. The key to ensuring further improvements in air quality, which currently imposes a welfare cost estimated to lie between 3% and 8% of GDP, will be the effective enforcement of laws by local environmental bureaux and ensuring that pollution emissions from major sites are carefully monitored. ■

Can development be sustained?

A marked evolution in economic polices over the past two decades has led to a long period of sustained economic expansion. National income has been doubling every 8 years and this has been reflected in the reduction of the poverty rate to much lower levels. Indeed, by some accounts, over half of the reduction in absolute poverty in the world between 1980 and 2000 occurred in China. At the other end of the scale, average incomes in major coastal areas are on a similar development path to that seen in other East Asian countries one generation ago. Considerable challenges face the economy, not the least of which is a rapid increase in the age of the population, but continued evolution of economic policies, especially in the areas of the allocation of capital, labour mobility, urbanisation and the creation of a improved framework for the development of the private sector of the economy, should ensure that this development momentum is sustained. ■

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- **Economic Outlook No. 77,** June 2005. More information about this publication can be found on the OECD's Web site at *www.oecd.org/eco/Economic_Outlook*.

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What should the state's role be?

How to modernise the tools of government?

How to co-ordinate different levels of government?

Is the institutional framework for market forces adequate?

What of the future?

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Introduction

China's economic reforms over the past two decades have brought remarkable growth, the development of a vibrant private sector and significant reform of the state-owned sector. Private businesses now represent some 57% of GDP, and productivity in the state-owned sector has improved significantly.

However, a number of problems threaten to undermine prospects for sustainable growth. These notably include social tensions, partly due to increasing inequality within society and massive migration to the cities, but also linked to corruption, insufficient public services and rising unemployment as millions of workers have been laid off in the reform of the state-owned sector, while agriculture still displays huge structural under-employment.

Economic growth alone will not solve all these problems: improved governance is crucial. If China's development is to be sustainable, the government needs to undertake a comprehensive programme of far-reaching institutional reforms to define the role of the state, improve management of public spending, and make public action more efficient and effective.

OECD members had identified governance as a priority topic for their ongoing co-operation programme with China, and to help meet these challenges, the OECD undertook a study of China's governance system, with China's agreement. Although the overall Chinese context remains very different from that of OECD countries, much can be learned from OECD reform experience. The project took stock of progress so far and examined remaining problems in budget processing and public expenditure, the tax system, the civil service, the fight against corruption, regulatory management and organisational structures. It also looked at how governance issues affect policy making and its effectiveness in 10 key sectors: labour policies, banking, competition, intellectual property rights, foreign investment, statistics, corporate governance, agriculture, environmental protection and higher education.

This Policy Brief looks at the lessons learned and the key governance challenges facing China in the coming years, seen from an OECD perspective. ■

What is the state of governance in China today?

China's rapid change is not only visible in the flourishing private sector enterprises and the radical renewal of its urban landscapes: it can also be seen in the transformation of its institutions. Over the past 25 years Chinese authorities have taken measures to adapt the role of government and public administration to an increasingly market-driven economy.

The administrative, productive and social service functions previously folded into a structure of closely linked organisations have been dispatched to different public and private organisations. State-owned enterprises have been separated from the public administration and new regulatory bodies have been set up. Chinese authorities have laid bases for modern tax, budget and civil service systems. China has also taken steps toward a system based on the rule of law, and has embarked on an ambitious regulatory reform programme.

Progress in governance was achieved in a relatively short period of time and has contributed in a crucial manner to sustain China's high growth rate. Such achievements are all the more commendable since the sheer size of China requires longer chains of command and multiplies the sources of potential problems.

In order to continue in this direction, China needs to sustain reform efforts in four key directions: the role of the state; the tools of government; relations between levels of government and the institutional framework for market forces. ■

Box 1

CHINA'S REFORM THEORIES

The theoretical framework underpinning the transition process may be traced back to the concept of the *Four Modernisations (sige xiandaihua)*, announced by Zhou Enlai in the mid-1960s and revived by Deng Xiaoping to launch the economic reforms in 1978. It envisaged the development of the Chinese economy until the middle of the 21st century by modernizing agriculture, industry, national defence and science and technology.

In the mid-1980s, Deng Xiaoping elaborated "three steps" for development. The first was to double the level of real GDP during the 1980s and thus solve the problem of inadequate clothing and food *(wenbao wenti)*. The second was to build a *Xiaokang (well-off)* society by the year 2000 by quadrupling the real GDP level. The third was to raise per capita GDP within 30-50 years to the level of an intermediate developed country. The concept of *xiaokang* society is particularly interesting since it was reused (and redefined) by Jiang Zemin to describe a "Chinese-style" modernization and notion of prosperity.

Jiang Zemin's concept of *Three Represents (sange daibiao)* in 2000 mainly served to re-orient and reposition the Communist Party of China, but it also officially legitimised private entrepreneurship for the first time.

Two concepts put forward by the fourth generation leadership (Hu Jintao/Wen Jiabao) in 2004, the *Scientific Development Concept (kexue fazhan guan)* and the *Harmonious Society (hexie shehui)* concept, take a more comprehensive approach towards development. They complement the discourse about the Chinese modernization path with a social dimension and stress the need to reconcile conflicts between rural and urban areas and between different social groups to promote social stability. The "Scientific Development Concept" accords high importance to the needs of individuals and to a co-ordinated and sustainable development. The *hexie shehui* concept is further linked to the notions of social welfare and more equal income distribution and to the rule of law. The concept envisages a closer relationship between government and people.

What should the state's role be?

The fundamental issue is to redefine the role of the state. Much has been achieved but, overall, the state needs to focus its efforts on areas where markets cannot accomplish national objectives.

In particular, the government needs to increase public expenditure in education, health, science and technology; improve the governance framework in sectors in which the state will remain active; overhaul the way it organises and manages public services; and tackle problems where new structures are operating alongside those inherited from the old system.

Public spending is currently too low in three key areas: education, where it is below the target of 4% of GDP fixed by the government; science and technology, where building a national system of innovation is crucial; and health, where private capital alone is unlikely to meet the increasing need for services. These gaps are important both for economic growth and for social cohesion.

China also needs to reduce spending on public sector administration. It is not easy to cut the public labour force, since in the poorer areas, public sector employment functions as a social safety net. But further efforts are needed.

The Chinese state will remain active, if not dominant, in a number of sectors. Important steps have been taken to change the governance framework of this participation, in particular by creating several regulatory bodies. But further efforts are needed in three key areas. Firstly, regulatory bodies need to be sufficiently independent from the entities they regulate. Secondly, there has to be enough distance between government authorities and regulatory bodies. And thirdly, the government needs to clarify its relationship with the regulators. It is also important to clearly identify the division of responsibilities between the different regulatory bodies.

The reform of public service units (PSUs), which deliver services such as health, education, science and technology, is a pressing issue. The stakes are high: there are 1.3 million PSUs employing some 25 million people. Before the reforms, they were owned and managed by the government, receiving funds from the budget to finance all their operations. They now have more autonomy to help deal with growing demand and insufficient public funding, but this has led to an increasingly complex situation.

Higher education institutions, for example, now receive only half their budget from public funds, with the rest coming from sub-national budgets, student fees and private sector contracts. The number of students has increased fifteen fold in 10 years. But relying heavily on private financing tends to increase social disparities, as higher education becomes accessible only to those who can afford it. It is also difficult to monitor quality and efficiency.

The government is embarking on an important reform of PSUs to clarify the role of the state, improve performance, and clarify management and accountability to ensure the PSUs serve the public and not themselves.

The reforms to date have also created problems where new institutions co-exist with structures inherited from the past. The government needs to deal with lack of co-ordination between closely related organisations and those whose mandates overlap, cases where hierarchical structure between organisations does not correspond to their mandates; fragmentation of decision-making responsibilities; and the co-existence of institutions with conflicting mandates. ■

How to modernise the tools of government?

China needs to modernise the regulatory framework and public management system – and adapt them to a market-driven economy if it is to use public resources more efficiently. This means producing clearer, less complex regulations and enforcing them, as well as reforming the budget process and the civil service and stamping out corruption.

China has improved the regulatory framework, strengthened the rule of law and in many respects, such as intellectual property rights or individual employment contracts, has adopted regulations well in line with international standards. But enforcing the rules remains a major challenge.

The government has significantly reduced the number of activities requiring administrative approval or licences and has streamlined the investment approval process. But many activities are still subject to a large amount of government control. The Chinese state should further reduce its intervention and shift the emphasis to providing services and infrastructure.

Efforts to streamline the regulatory framework of private businesses should be pushed further. China's moves to simplify administrative regulations in taxation are commendable but there is still a long way to go.

But the main challenge in this area is applying and enforcing regulations. Laws and regulations are not applied in a systematic way, and can be biased by corrupt arrangements or local balance of interests. A lasting solution requires strengthening formal systems of financial and performance audit, and improving the judicial system.

In addition and more fundamentally, if regulations are to be successfully applied and enforced, those being regulated must basically be willing to comply. This depends not only on punishing violations, but also on the quality of regulations and public participation in creating, applying and enforcing them, which in turn implies access to information. The nature of the political regime necessarily places constraints on possible progress in public participation and access to information. The government has taken positive steps on access to information, in part linked to the WTO accession process. But progress is uneven at the local level.

China has made progress in creating the infrastructure for a modern budget management system and civil service, the two principal pillars of public management, along with e-government and simplifying administrative procedures.

But several weaknesses still afflict the budget system, not least the fact that the finance ministry does not have comprehensive oversight authority on spending. So far the government has focused mainly on tackling technical issues, and has shied away from reforms that more directly involve political challenges. In particular, there has been little public discussion of the need for a major realignment of the intergovernmental fiscal system. Other important steps for the future include refocusing budget priorities and limiting policy initiatives which are not disciplined by the budget process.

The Chinese government has undertaken extensive reforms to its civil service system over the past 10 years but many challenges remain. One is to ensure that the rules for recruitment, reward, promotion, etc. are applied. At present, not all recruitments go through the established mechanisms.

Such administrative reforms are necessary to enable China to introduce a unified information technology system. But the success of e-government programmes depends on progress on other fronts, including administrative reforms that standardise operational procedures and clarify responsibilities, and strengthening the rule of law.

Finally, corruption is one of the most important problems in China today. China has undertaken a number of measures to more effectively detect and punish corruption. Reforms have primarily focused on the penal regime as well as on the disciplinary system for officials and Party members. More attention should be paid to reviewing areas prone to corruption, eliminating opportunities for corruption and creating conditions conducive to ethical behaviour. ■

How to co-ordinate different levels of government?

Adjusting the relations between levels of government is equally important. Finding a way to ensure that local governments have the resources to meet their responsibilities and use them in accordance with national objectives is a major governance challenge in China as in OECD member countries.

Although in theory central government has fiscal control over local governments, there are persistent enforcement problems at local level. There are also tensions due to inadequate public services at local level, rising inequalities between provinces and between rural and urban areas, corruption, mismanagement and imposition of illegal taxes.

Divisions of responsibility and accountability are often unclear. Take land ownership rights. These are not clearly defined and authority over them is diluted across various levels of government, leaving considerable scope for arbitrary decisions by local leaders.

Local governments have taken on major new expenditure responsibilities in recent years such as education and health, but without receiving the funding to meet them. To make matters worse, local governments are not always consulted about central government policies that will cost them money. Most local officials reportedly learned of a salary increase for civil servants from TV broadcasts even though the costs were mostly borne at local level. But consultation with local governments has clearly improved in recent years. For example, recent reforms in rural fees and agricultural taxes have been worked out with local governments.

The shortage of revenue at local level makes it difficult to implement national policy on social security, basic education and health. Health ministry figures show that the 900 million rural Chinese receive only 20% of the country's medical resources although they account for 70% of the country's population.

A major consequence has been the growth of illegal taxes and fees, as well as corruption. When pay is seriously in arrears, for instance, there is great temptation to use official power to extort bribes.

These problems are all the more important in an increasingly market-driven system, which tightens budget constraints and increases pressure for efficiency.

Reforms have been undertaken to reinforce vertical lines of authority in various areas, notably the tax system. But improving co-ordination between the central and local levels will also require progress on other fronts: improving sub-national governments' capacity to properly handle new responsibilities, developing external control mechanisms at local level, reforming incentive mechanisms for local leaders, and increasing participation of local leaders in debates on national policies. ■

Is the institutional framework for market forces adequate?

Market-driven economies need just as many institutions as planned economies, albeit of a different type, covering areas such as the labour market and labour protection, tax system, sound competition rules, intellectual property rights and corporate governance.

China's economic reforms have established a new relationship between enterprises, workers and the state, shifting the government's responsibility toward promoting efficient labour markets and replacing the "iron rice bowl" with a social safety net.

Specialised labour office networks have been developed in urban areas, but much less so in rural areas, where further rapid expansion will be needed. The labour inspectorate supports the enforcement of labour policies, not least by responding to individual workers' complaints. But limited social insurance coverage and labour protection contribute to continued labour market segmentation that distorts the competitive climate and income distribution.

Implementing labour law and social insurance is generally difficult in the less-productive rural and informal segments of the labour market. But the present scale of rural-urban migration and economic interdependence makes it urgent to reduce the inequity of the system as far as possible. The pension programme, for example, currently requires 10 contribution years in the same locality, but should be equipped to take account of all contributions made by an individual during his or her lifetime, regardless of where they were paid.

Competition is recognized as key to economic efficiency. Key areas of a sound competition framework include tax policy, competition policy and intellectual property rights. A new round of tax reform is now needed to bring the tax system up to date. Based on the experience of OECD member countries it would be beneficial for China to follow the example of many transition and developing economies and progressively adopt a national competition policy.

When it comes to intellectual property rights (IPR), in the past two decades, China has adopted a set of laws and regulations that basically conform to current international practice and standards. The main continuing problems are lack of transparency at local level and enforcement. A Chinese official report estimated that counterfeit goods worth between USD 19 billion and USD 24 billion were on the market in 2001 alone – an amount comparable to the GDP of Tunisia. OECD countries' experience suggests that enforcement campaigns alone will not solve the problem. China needs a multidimensional strategy, which would include reorganising the enforcement system and raising participation of non-government groups.

Corporate governance is also vital. Traditionally there have been different sets of rules for state-owned entities, collective enterprises and foreign-invested companies, although the authorities have made much progress in recent years toward placing all businesses on a comparable legal and regulatory basis. A comprehensive change in company law now being drafted is expected to largely complete this process.

China has to a certain extent brought its corporate governance codes for listed companies into line with international practice. However there remain some important gaps. Many state-owned assets lack boards and other essential governance structures. Chinese authorities have long recognised the critical importance of stock markets in underpinning the effective corporate governance of listed companies. Until fairly recently, though, the stock markets were used more to support state-owned enterprises than to encourage private business or bolster corporate governance. The government has been making vigorous efforts to address the weaknesses and is putting into place a new regulatory framework for listed companies aimed at protecting investors' interests and based on the principles of "transparency, fairness, and justice". Nevertheless, much remains to be done, particularly in terms of enforcing existing laws and regulations.

Corporate governance of banks presents special challenges. Banks in China have been moving away from their passive role in allocating credit according to state directives under the planned economy. But in most cases their ownership structures and governance regimes are not yet adequate to allow them to serve as purely commercial entities. This is particularly important in the case of the four large state-owned commercial banks which account for the predominant share of bank assets. Strong efforts are being made to improve the corporate governance of these banks by converting them into commercial companies with modern governance structures. But it is unclear how far the reforms will go toward making them operate as market-based institutions. ■

What of the future?

Governance reforms, in China as everywhere else, happen incrementally, when favourable political circumstances coincide with technical capacity. On all the identified governance weaknesses, China will need to ensure that it has the technical know-how to proceed as and when the circumstances allow. Although the overall Chinese context remains very different from that of OECD member countries, much can be learned from these countries' reform experience. Through extended exchanges with OECD practitioners and experts, China could draw lessons on various technical aspects of the system of governance as well as on implementation strategies. ■

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OCTOBER 2005 Policy Brief

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Agricultural Policy Reform in China

How have previous policy reforms changed agriculture?

Can current growth continue?

Are current policies effective?

How would more open trade benefit China?

What are the main policy challenges for the future?

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Introduction

China is the world's sixth largest economy and its most populous country, home to 1.3 billion people or 21% of the Earth's total population. But it faces a major challenge in providing its people with food – China has only 10% of the world's arable land and only one quarter of the average world water resources per person.

Agricultural reform has therefore been a major pillar of the fundamental economic reforms undertaken by China since 1978, resulting in a gradual transition from a centrally planned economy towards a socialist market economy. The commune system was replaced by one where individual families lease land from the collectives, ensuring that almost all rural households have access to land. Then, rural industries started to expand and absorbed a large part of farm labour. The reforms have achieved a sharp rise in agricultural production together with a dramatic fall in poverty and a significant improvement in the amount and quality of food available.

These changes have provided a major contribution to China's remarkable overall economic performance in the past 25 years, which has seen growth in real GDP average above 9% between 1990 and 2004 with even more rapid growth in trade and investment. China's accession to the World Trade Organisation (WTO) in 2001 confirmed a further strengthening of the reform course it has been following for the last 25 years.

A unique element of China's experience is that the bulk of the shift in employment has taken place within the rural economy, as agricultural workers moved to newly-developed non-agricultural industry, rather than through migration from rural to urban areas.

This Policy Brief provides an overview of the agricultural policy reform in China, its impacts on agriculture, the challenges facing the sector and the suggested directions for further policy reforms. ■

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How have previous policy reforms changed agriculture?

During the reform period China's agriculture sector experienced phenomenal rates of growth. The introduction of the Household Production Responsibility System (HPRS), where families lease land from the collectives, boosted production incentives, encouraged farmers to reduce costs, take risks, and enter new lines of production. At the beginning of the 1990s, when the economy grew very rapidly, consumers shifted their preferences from quantity to quality. A new phase of adjustments started in the late 1990s and in the early 2000s when oversupply emerged on most agricultural markets, causing grain prices to fall, and increased exposure to international competition stimulated further structural changes. The main policy objective shifted to raising farmers' incomes.

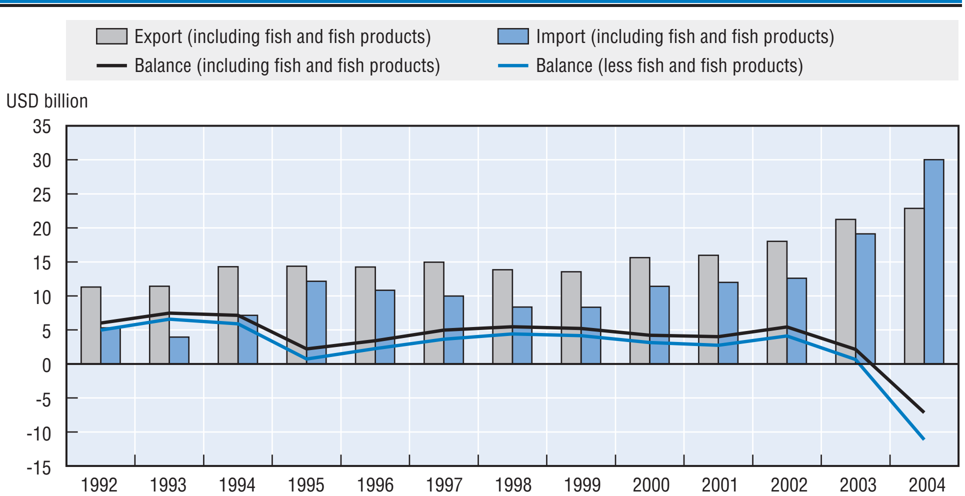
While cereals remain the key crop, their share in total crop production and in the area sown has declined quite substantially since the early 1990s as other crops became more profitable and the government relaxed most of the policy measures which had previously required farmers to produce grains. Impressive increases in vegetable and fruit production reflect China's comparative advantage and responsiveness to changes in domestic demand, as well as to emerging export opportunities for selected products such as garlic, onions, apples, and pears.

China's agriculture is characterised by scarce land, abundant labour and small-scale production using little mechanisation. The overwhelming majority of crop production originates from tiny farms averaging just 0.65 ha – in 2005, there were some 200 million of these. While a large part of livestock production also comes from small, part-time "backyard" operations, full-time "specialised" household operations and commercial operations have grown rapidly.

Agricultural output per unit of land is high by international standards but output per worker is low. Limited arable land and a large rural labour force mean that in general China tends to have a comparative advantage in producing labour-intensive crops such as fruits and vegetables and a

Figure 1.

CHINA'S AGRICULTURAL TRADE, 1992-2004



Sources: Comtrade database; China Customs Statistics for 2004.

disadvantage in producing land-intensive crops such as grains and oilseeds. However, the situation is quite strongly diversified regionally and depends on availability of land and water, climatic conditions, transportation costs and access to markets.

The land tenure system is based on land lease contracts. Farmland is *de facto* owned by village collectives which extend 30-year land lease contracts to individual farm households. Households can use, sub-lease and transfer the land, but they cannot sell it.

In the early stages of reform, land tenure policies were based on the HPRS and the principle of egalitarian access to land brought a number of positive effects. Compared to the communal system, the HPRS provided farmers with stronger rights to land and to production, which stimulated growth in agriculture and rural incomes. Through equal distribution of land use rights, China avoided having large numbers of rural landless workers vulnerable to famine or other economic shocks. It has also ensured that the vast majority of rural households are, at minimum, food self-sufficient.

However, the current land tenure system is increasingly revealing its limitations. Land market transactions are limited and land rental arrangements between farmers tend to be informal, short term and most often between relatives. There is also scope for arbitrary decisions by local leaders, and for conflict situations to arise between village leaders and farmers, including when local regulations limit land transfer rights. There are also a large number of cases when local leaders, assuming the role of landowners, decide to lease or sell land to external investors without consensus from local farmers and without farmers receiving proper compensation for lost access to land.

The agro-food sector (including fisheries) remained a net export earner at about USD 5 billion a year until 2002. In 2003 and 2004, following several consecutive falls in grain production and having overcome some early problems with the implementation of the tariff rate quota (TRQ) system agreed within the WTO, agro-food imports increased at high rates leading to net imports of agro-food products at about USD 11 billion in 2004 (Figure 1).

One of the remarkable achievements of the reform period has been the strong growth of real per capita rural incomes, largely due to the rise in non-agricultural employment opportunities. Real rural income rose more than three-fold between 1980 and 2000. The overall rise of incomes in rural areas, including those in poor areas, has led to a dramatic fall in poverty. This is all the more important since some 99% of China's poor live in rural areas. Using China's standard of income below USD 0.6-0.7 per day, the number of people living in poverty fell from 250 million in 1978 to 29 million in 2003. In other words, the proportion of the rural population affected by poverty fell from 31% to 3% during the period. Based on the World Bank definition of poverty (income of USD 1 per day), the number of people living in poverty in rural China was still high at 88 million in 2002, but the progress in eliminating poverty is still remarkable, with about 400 million people rising above the poverty line between 1979 and 2002.

China's rural poor are mostly concentrated in the western provinces and in localities that lag in terms of growth, are remote, sparsely populated, poor in human and natural resources, and weakly linked to the rest of the economy. This makes further reduction of poverty more difficult and partly explains a relatively slow fall in poverty levels since the mid-1990s. Moreover, rural communities just escaping from poverty are quite often strongly dependent on weather conditions and are likely to fall into poverty again when these conditions deteriorate. As the social security system is almost non existent in rural China, little public assistance is available to those families which suffer most.

Despite the rapid reduction in poverty levels, overall the rise in rural incomes was not sufficient to close the gap with urban areas as differences in labour productivity between agriculture and the rest of the economy and, more generally, between rural and urban areas persisted. In fact, the income gap has widened as the reforms progressed. Per capita income in urban areas was 1.85 times that in rural areas in the mid-1980s, but by 2003 and 2004 the ratio had risen to 3.2, the highest over the whole reform period. ■

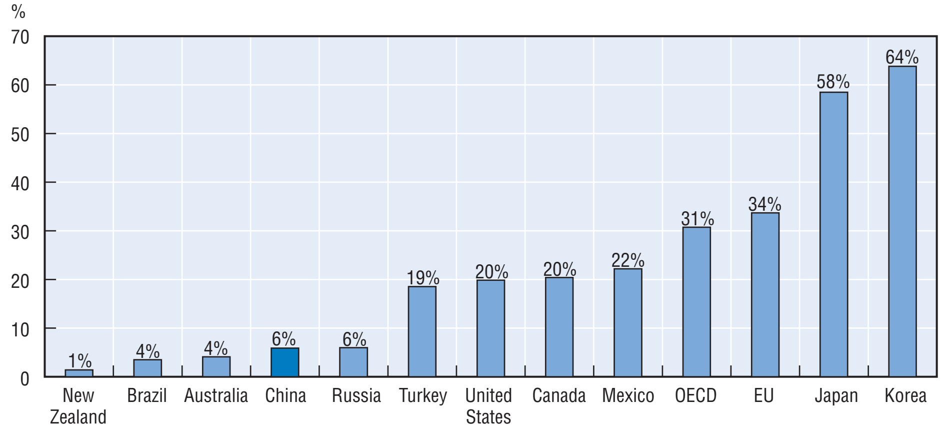
Can current growth continue?

The high rates of agricultural production growth obtained over the first two and a half decades of the reform period cannot continue indefinitely. Prospects for further substantial gains in agricultural labour productivity will likely depend on labour moving away from agriculture to other sectors of the economy. This will secure higher incomes for those remaining in the agricultural sector and those leaving should benefit from higher incomes due to more efficient use of labour in non-agricultural sectors. In fact, the income distribution across rural areas in different parts of China depends increasingly on the availability of non-agricultural job opportunities in rural areas and on people moving to urban areas in search of work. As the availability of jobs is highly uneven, the variation in per capita income by province is much greater for rural than for urban areas.

In the past, China had boosted food production by increasing the amount of land being used for agriculture. In recent years, however, the area of

Figure 2.

PRODUCER SUPPORT ESTIMATE IN CHINA AND SELECTED COUNTRIES, 2000-2003 AVERAGE
As per cent of gross farm receipts



Note: EU15.

Source: OECD PSE/CSE databases 2005.

cultivated land has been decreasing, and the focus has been on using more fertiliser, pesticides and mechanical inputs to increase productivity. But this more intensive chemical-use system of farming is creating its own problems. China's use of fertilisers, at 280 kg per hectare, is one of the highest in the world. Urban and industrial growth have also put pressure on agricultural land and water resources, while agriculture is itself directly affected by pollution from other human activities, especially industrial production. Some of the ecological problems are location-specific, such as desertification in northern China, whereas others are common across the country, such as land degradation, soil erosion and water pollution. These problems risk contributing in the long term to a reduction in agricultural productivity. ■

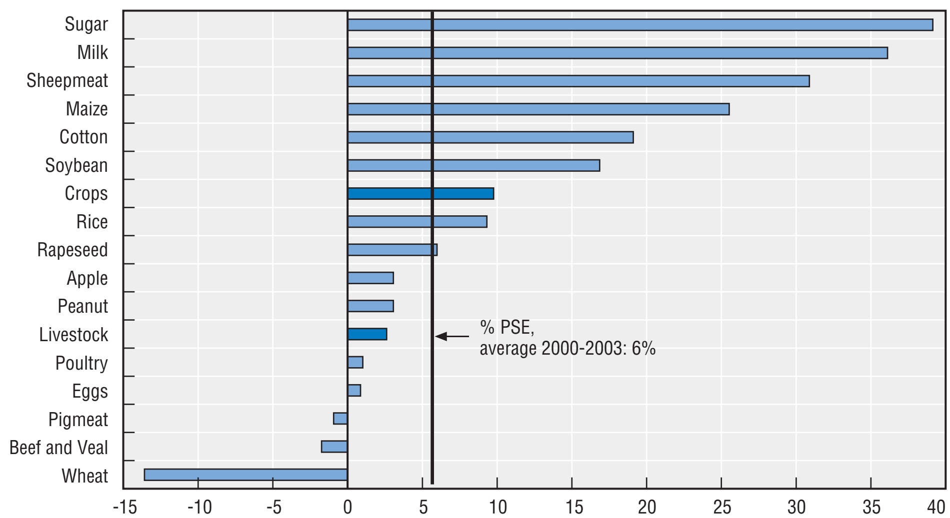
Are current policies effective?

China does provide support for its farmers, but well below the levels of its closest OECD neighbours, Japan and Korea, which are also its main export markets for agro-food products (Figure 2). The level of policy support to China's agriculture, measured according to the OECD's Producer Support Estimate (PSE) fluctuated at low levels through the 1990s, rising to 6% of gross farm receipts in 2000-2003, little less than a fifth of the OECD average of 31%. However, the mix of measures used to support China's farmers is dominated by price support and input subsidies, among the least efficient and most trade-distorting ways of providing agricultural assistance.

And while overall producer support is low, the level varies significantly. The highest levels of support are for commodities facing competition from imports, such as sugar, milk, sheep meat, cotton and soybeans, as well as some export commodities such as maize and rice (Figure 3). The distortions on grain markets are still relatively high, mostly due to state trading, which continues to drive a wedge between domestic and world prices. In contrast, for the majority of exportables, such as pig meat, beef and veal, eggs, peanuts and apple, the level of support is low.

Figure 3.

CHINA'S PRODUCER SUPPORT ESTIMATE BY COMMODITY, 2000-2003 AVERAGE
As per cent of gross farm receipts



Source: OECD PSE/CSE databases 2005.

A slightly different picture emerges using the Total Support Estimate (TSE), the broadest indicator of support which in addition to PSE includes expenditures for general services, such as agricultural infrastructure, and direct budgetary transfers to consumers. Total support to China's agricultural sector reached USD 41 billion per year in 2000-2003 which is equivalent to 3.3% of China's GDP in this period. This percentage is much higher than the OECD average and suggests a relatively high burden of agricultural support on the Chinese economy. However, it also reflects the economic importance of agriculture in a relatively poor economy, and is partly due to large budgetary investments in agricultural infrastructure, to improve productivity. These expenditures are a positive feature of China's policy as such support has desirable long term impacts and minimal distorting effects on production decisions and on trade. ■

How would more open trade benefit China?

Any world agreement to further open up agricultural trade would improve China's access to overseas markets, raise world market prices for agricultural commodities, and generate income *gains* for China's farmers. At the same time, higher world market prices lead to higher *costs* for consumers of some agricultural goods, although some domestic consumer prices would fall with a reduction in China's own agricultural tariffs as part of a multilateral market opening agreement.

But agreement to further open up world agricultural markets would not have much effect on China's overall welfare. Net trade constitutes only a small fraction of China's agricultural output, and the gain in farm incomes would be just about the same as the consumer loss due to higher prices.

Reductions in the tariffs OECD countries charge on non-agricultural merchandise could, however, mean significant welfare gains for China, both in its agricultural and non-agricultural sectors, without increasing the adjustment pressures associated with the current trend of net migration from rural to urban areas.

Using this analysis to simulate the welfare effects of multilateral trade liberalisation on a sample of rural Chinese households, it was found that welfare would improve for the vast majority (91%) of them. Welfare changes might be substantial, at 2.8% of pre-reform income levels for the average household in the sample. The very few who would lose out from reform typically live in communities poorly endowed with agricultural potential, physical infrastructure and human capital. ■

What are the main policy challenges for the future?

As the economic situation and sectoral performance have improved, government priorities have shifted from increasing production, especially of food grains, to rural income support and more recently to environmental concerns. In the medium term, the main challenges for China's policy makers include:

- closing the large income gap between rural and urban populations;
- integrating small-scale farmers into markets;

- stimulating internal reallocation of resources to create more efficient farm structures;
- reducing the negative impacts of agricultural production growth on the environment;
- improving the competitiveness of agricultural and food products on domestic and international markets;
- improving the governance of institutions in designing and implementing agricultural policies.

Policy responses should be based on economy-wide measures such as further relaxation of administrative barriers to rural/urban migration, improved access to education in rural areas, better health care, pension and other social security services, enhanced land property rights and rural tax reforms. The provision of modern research and extension services, food safety agencies and agricultural price information, services which provide widespread benefits to producers and consumers throughout the economy will also be of crucial importance. ■

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POLICY BRIEF

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Attracting Investment to China

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Introduction

Foreign investment has played an important role in China's economic development for almost a quarter of a century and is vital for that development to continue. But while China has been highly successful in attracting foreign direct investment (FDI) so far, and has made significant progress in improving its FDI policy framework, it has not fully exploited its potential to attract investment from OECD countries.

To make the most of the potential benefits of joining the World Trade Organization (WTO) and to increase FDI inflows while enhancing their contribution to domestic development China will need to persevere with efforts to bring its laws and regulations into harmony with internationally recognised standards and to ensure they are fully and consistently implemented at local level.

A new *OECD Investment Policy Review, China: Progress and Reform Challenges*, looks at progress to date in China in attracting foreign investment and in moving towards a more rules-based business environment. It suggests policy choices designed to increase the amount of foreign investment from advanced countries. ■

oecd Observer

What has foreign investment done for China?

China has made significant progress in providing a business environment conducive to FDI since the major shift to economic reform in 1978. A closed economic system has been rapidly opened to trade and investment. Major economic institutions have been replaced or transformed. Others, like the state-owned enterprises and the financial system, are undergoing lengthy reform that will bear fruit in the future.

FDI has played an important role in this transformation. It has enabled China to establish new branches of industry and Chinese consumers to experience a far wider range of goods and services. It has brought in new technology in many fields. Foreign-invested enterprises have provided employment, directly or indirectly, to millions of people, as well as training and experience in both technological and managerial skills which can be transferred to domestic enterprises. FDI has played a major role in expanding China's international trade, which is now equivalent to half of the country's gross domestic product (GDP), with foreign-invested enterprises accounting for half of all two-way merchandise trade.

Even so, China receives far less FDI per head than many other developing as well as developed countries. For example, in 2000 China received USD 30 per capita while Brazil received USD 195 and OECD member countries an average of USD 1,321 (see table below). Much FDI in China still goes to short-term, labour-intensive manufacturing, while investment in high-tech activities, particularly in services sectors, lags behind. There is therefore still much scope for raising the quality of FDI as well as continuing to increase its quantity. ■

How to attract high-quality FDI?

The challenge for China now is to improve further its policy framework in order to attract more long-term, capital-intensive, high-tech projects in more sectors of the economy and hence to reap the maximum benefit from spillovers of skills and expertise from the foreign corporate presence.

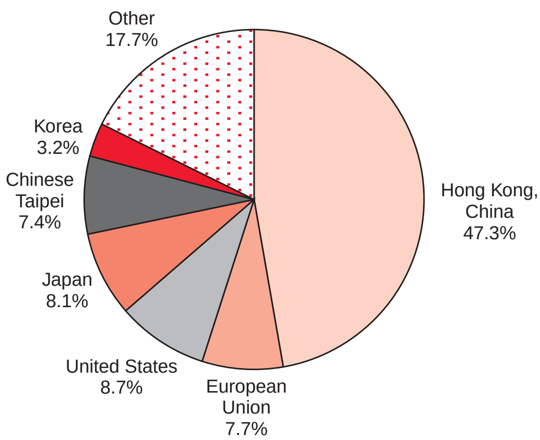
China's accession to the WTO has already brought about major advances in FDI policy. In addition to the removal of trade-related investment measures, China is also opening up its services sectors, including the financial sector. Existing foreign-invested enterprises are now able to distribute their products in China and engage more widely in for-

FDI inflows per capita to China and selected countries and territories, 2000 (US$)

Country or territory	FDI per capita
China	30.1
OECD average	1,320.9
India	2.2
Indonesia	-21.6
Malaysia	162.8
Myanmar	5.3
Philippines	16.3
Singapore	1 547.2
Thailand	54.0
Vietnam	16.7
South Africa	22.2
Argentina	314.8
Brazil	195.4
Chile	241.6

Source: *Calculated from* IMF, *International Financial Statistics*, *October* 2002.

Shares of the main countries, regions and territoires in FDI inflows to China, 2001 (%)



Source: MOFCOM statistics.

eign trade. These changes will provide opportunities for enterprises based in OECD member countries to play a bigger role in making direct investments in China.

Multinational enterprises in OECD countries have the capital and the technology to provide longer-term projects embodying advanced production methods. However, OECD members have so far provided a disproportionately small amount of FDI to China, at least partly because of perceived weaknesses in the legal and regulatory framework for investment.

In the early period of reform and opening up of the economy, China's offer of incentives such as lower taxes was effective in attracting foreign investors. But now China is well on the global investment map, it is not clear that such a rich set of incentives is necessary for attracting FDI. Indeed, recent surveys show that foreign investors are much more concerned about the overall regulatory regime than about incentives, and that they prefer to locate investments, especially large, long-term ones, in countries with predictable policy regimes.

Beyond offering fiscal incentives, the Chinese government has in fact worked hard to make investment easier by measures such as reducing delays in approving FDI projects and improving the physical infrastructure. A rules-based investment environment is also now gradually beginning to take shape, though there is still much to be done.

China is striving to develop an impartial and effective court system, but, for institutional and manpower reasons, this work will take years, rather than months. Effective implementation of law matters because investors, whether foreign or domestic, need to have guaranteed property rights, including intellectual property rights (IPR). Much stronger implementation of China's IPR protection legislation and its international commitments in this regard is needed, not just to attract FDI but also to stimulate domestic creativity. As the history of world technology shows, Chinese people are themselves highly inventive when the institutional framework allows them to be so. The sharply rising number of domestic patents is testimony that this is still true.

Investor confidence also relies on a legislative and regulatory regime that is stable, internally consistent and publicly available in an understandable form. Coherence between national and local legislation and regulation is encouraged by WTO, OECD and other internationally recognised standards. The existence of undisclosed internal rules for approval of investment projects, for instance, is not compatible with the principle of transparency.

Consultation with the foreign investor community on new FDI-related legislation and regulations does now take place, but it still tends to be selective, so that some major foreign investors who consider themselves to be the key players in a specific sector complain about being left out. In OECD countries, the free climate of discussion and debate facilitates the formulation of new laws by allowing the public, including all interested parties, to raise objections and make suggestions before laws are passed. Waiting until after the laws are promulgated to find out what are the problems in implementing them complicates the situation by obliging the government to issue, in addition to the original law, sets of implementing regulations and revised laws.

Even where a dominant state-owned enterprise has been partly privatised, there is no guarantee that it will cease to exercise monopoly power not justified by the nature of the market concerned. Competition policy needs to be strengthened to make it easier for new companies, whether domestic or foreign-invested, to enter the market. Competition policy is particularly important as state-owned enterprise reform reaches a new stage in which foreign corporations play an increasing role in privatisations, allowing them to contribute positively to industrial restructuring that will greatly increase industrial productivity.

The increasing part played by mergers and acquisitions in FDI will necessitate more effective prudential regulation of China's capital markets and a visible improvement in the general standard of corporate governance. Bank reform will also have to be completed if the financial system is to be strong enough to fulfil its function in this process. ■

Will a rules-based investment environment help domestic enterprises?

The experience of OECD countries is that a regulatory environment that is conducive to competition and in which foreign-owned enterprises are generally treated no differently from domestically-owned ones provides the best basis for developing home-grown enterprises. China's own experience is also instructive in this regard. The enabling environment established for foreign business in the Special Economic Zones (SEZs) and other open areas has also encouraged the emergence of thriving domestic private enterprises, which represent a larger share of output there than in hinterland provinces. Most of the cases heard by the IPR courts, which were established partly in order to respond to problems faced by foreign investors, have been brought by domestic plaintiffs. Those industrial sectors that have been opened wide to FDI are already characterised by more successful domestic firms, while protected sectors have generally remained dominated by state monopolies that are often inefficient and provide customer service that is not always satisfactory. Fears that liberalisation of these sectors would lead to domination by foreign-invested enterprises are largely unfounded, provided such liberalisation is accompanied by the development of vigorous anti-monopoly and competition legislation applied in non-discriminatory fashion to both domestic and foreign firms. ■

How can FDI policy serve China's regional development aims?

Foreign-invested enterprises are offered the same incentives as domestic enterprises to invest in the Western and Central regions, which are poorer and less developed than the Eastern coastal region, but this is not enough to entice them away from the more established areas. If the Chinese government wishes to redirect investment westward, it may prefer to put the main emphasis on improvements in the business environment in the hinterland provinces. The current policy of allocating state funds to infrastructure construction in the Western and Central regions is an important part of this effort.

But institutional development is also necessary. Steps to ensure this could include raising the standard of investment promotion and investment approval in these regions to that prevailing in the open coastal zones, where the authorities are generally much more flexible in their interpretation of FDI laws and regulations. The government could also organise visits by officials from the Western and Central regions to their counterparts in SEZs and other open zones in the Eastern Region to share experience and gain a deeper understanding of procedures that have been successful in attracting investment. Such measures would be relatively cost-effective and remain useful even if the "invest in the West" policy were to be modified. ■

How to make things simpler for investors?

Proposed foreign investment projects are divided into a fourfold classification categories: encouraged, restricted, permitted and prohibited categories. The so-called "catalogue" of 'permitted' investment projects – far longer in practice than the other three – is not in fact a published list, but consists of all projects not listed in the other three categories, which are published as separate catalogues.

Following WTO accession, China reduced the number of prohibited and restricted project types and increased the number that are permitted and encouraged. The Chinese authorities are to be commended for this step and encouraged in their efforts to achieve further liberalisation of the catalogue regime.

More categories of project could be removed from the list of prohibited foreign investment industries. The inclusion of sectors where national control is considered desirable, such as projects that endanger the safety and performance of military facilities, is understandable; where not self-evident, an explanation of the reasoning involved would be helpful. For instance, China currently prohibits FDI in a few traditional crafts such as the production of green tea, traditional Chinese medicines, bodiless lacquer ware, rice paper and ink tablets. The intention of this prohibition is presumably to ensure the continued existence of these activities because they are considered to be part of the national heritage. If this is the case, the prohibition of inward financial flows supporting such activities would appear to be an inappropriate means of achieving such an aim, which might more effectively be pursued by other measures, for example by increasing the resources available for education and training in these fields. Another category of prohibited FDI is the establishment of futures companies. There appears to be no advantage to be gained from banning FDI from entering this financial sector that could not be more effectively obtained by imposing appropriate prudential regulation covering both domestic and foreign-owned enterprises.

It is therefore not immediately clear that there is any benefit in maintaining an extensive "restricted" list, effectively raising the approval hurdle higher for a wide range of industries and services, including, it is important to note, most of the services sectors being opened as a result of WTO accession. The Chinese government could consider abolishing this category entirely when it considers further opening to foreign investment to be appropriate.

Unlike the other two published categories, the "encouraged" category does not restrict FDI in any way. The future of this category will largely be determined by the Chinese government's policy regarding FDI-attracting incentives. One reason for questioning the need for its continued existence is the increasing length and complexity that have resulted from successive liberalisations. The list is now so detailed that many of the items are likely to become rapidly obsolete as a result of technological progress.

A clearer presentation of the permitted range of foreign investment activities could be achieved by replacing the catalogue regime with a single short list of sectors that are barred to foreign participation, supplemented by a clear explanation of the grounds for selection. All projects not on the list would then be permitted.

One problem that appears to persist is that internal regulations (neibu) governing the process by which FDI projects are approved still exist alongside public regulations (gongkai). The internal local regulations, which are not published, are said to be generally more restrictive than national legislation and regulations but unless they are made public it is not possible to judge whether or not they are acceptable. The Chinese government is committed to solving this problem. A rational solution would involve a two-step procedure. First, local neibu rules could be made available to the public, including foreign investors, as well as any internal regulations still operating at national level. The government could then abolish any that are inconsistent with national law, other regulations, or international obligations. If they were worth keeping, they could be re-issued as public regulations.

But China's existing international commitments are a milestone on the road to liberalisation, not full liberalisation itself. Further measures that could help include streamlining the approval process for FDI to avoid unnecessary delays and obstacles, for instance by raising the value of a project that local authorities can approve without having to refer it to central government departments. The government could also merge the various steps in the approval process to produce a genuine "one-stop shop" system. The national-level approval process could also be given more resources and reorganised to make it more efficient, and the government could consider introducing automatic approval within a reasonable time limit for all projects meeting the published approval criteria in full. ■

Is the financial sector open enough?

China has committed itself to a major opening of the banking sector to foreign participation. However, the regulations promulgated by the People's Bank of China (PBC) in February 2002 set such high capital requirements for setting up branches in China that only the largest foreign banks will be able to take advantage of the new opportunities. While the requirements for opening a representative office are relatively modest, those for establishment are much more strict: the parent bank must have USD 20 billion in total assets to open a branch and USD 10 billion to open a subsidiary. The minimum capital requirements in the latest Chinese legislation apply only to foreign, not domestic, banks, but assessing the extent to which this should be considered as discriminating against the establishment of foreign banks is complicated by the fact that there are no private banks in China and state-owned domestic banks are the subject of to a different set of regulations. Considering that the regulations also include reasonable stipulations requiring foreign banks to be governed by adequate supervisory systems in their home countries and to possess adequate internal control systems, such high capital requirements appear in any event disproportionate to guarantee stability and are interpreted by some representatives of foreign banking institutions as protectionist. Lowering the capital requirements for overseas banks to less discouraging levels would help open the banking sector to foreign participation.

Portfolio FDI inflows are also restricted by the largely closed nature of China's capital markets. At the same time, the expansion of foreign-invested enterprises is limited by restrictions on capital-raising measures such as corporate bond issues. Allowing more foreign-invested enterprises to list on domestic stock markets and to issue corporate bonds on the Chinese market would help enable portfolio inflows to play a more effective role in enhancing inward FDI and in fostering the development of Chinese securities markets. ■

How to make the system more transparent?

Both actual and potential foreign investors would find it easier to plan investment projects if they could obtain a clear and consistent picture of all relevant elements in their operating environment in China. There are a number of ways in which the Chinese government could enable them to do so.

Governments are increasingly using the Internet to communicate information to their citizens and those of other countries, and as a transparent, cost-effective and efficient way of supplying government services. China has made great progress in establishing websites for government departments which in many cases are readable in English as well as Chinese. The quality of these official web sites varies widely. Some are user-friendly, easily navigable, rich in content and frequently updated; others bear the hallmarks of neglect, with obsolete and irrelevant content, dead links, navigation problems and no pages in non-Chinese languages.

Sites dealing with issues of interest to foreign investors have until recently displayed a similar quality variability. And although the best of them are actually much better than those of most other developing – and some developed – countries, they are not always easy to find. There were until 2003 several national-level sites, with no clear indication for the uninitiated as to which was predominant. But the problem of establishing a single easy and reliable method of finding an authoritative source of information on China's FDI policies, laws and application procedures on the Internet is relatively easy to resolve. The OECD welcomes the inauguration of MOFCOM's FDI-related web site, www.fdi.gov.cn, at the beginning of 2003 and offers its continued assistance in helping to ensure that the site is up to date, contains appropriate content in both Chinese and English, and is easily navigable.

It would also be good practice to ensure that authoritative versions of all tax regulations promulgated by the Ministry of Finance (MoF) and the State Administration of Taxation (SAT) relating to a foreign investment project, including all related rules and incentives, be made available on a regularly updated basis in English to foreign investors and members of the public requesting them. This may be done in print, on a web site, or preferably both.

The obligations of foreign-invested enterprises towards their employees in regard to the payment of social benefits remains inconsistent and unclear. This situation could be remedied by developing and implementing a consistent national body of regulations governing the entitlement of employees to social and pension benefits and clearly specifying the contributions to be made by employers to such benefits. Establishing mechanisms whereby both employers and employees can ascertain their individual pension and other entitlements in a fully transparent manner would also help. ■

How to improve the legal system?

Current efforts to improve the functioning and independence of the legal system could be intensified by training and appointing legally-qualified judges to all courts and enhancing their status in relation to local government and party officials. Raising judges' pay, as well as that of other key legal personnel, could help reduce their vulnerability to offers of bribery. Establishing national and regional mechanisms to ensure that court judgements were carried out would also be helpful.

The Chinese government may wish to explore the possibility of establishing a mechanism to publish draft laws and regulations and obtain public feedback on them as early as possible before promulgation, as happens in several OECD countries. In the case of FDI-related legislation, it could be helpful to design a more consistent and comprehensive method of organising such consultations, involving all major players. A full consultative process would also include an open public debate on proposed legislation, using print and electronic media. This would be particularly helpful in the case of complex legislation. Such a procedure might be adopted on a trial basis in the case of proposed business legislation, such as that on mergers and acquisitions. ■

For more information

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For further reading

- **OECD Investment Policy Review of China: Progress and Reform Challenges**, 2003
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- **China in the World Economy: The Domestic Policy Challenges**, 2002
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