Supporting Report 1

China: Structural Reforms for a Modern, Harmonious, Creative High-income Society

Table of Contents

Boxes

Tables

Figures

Executive Summary

China's remarkable economic growth over the last three decades has brought many positive results and set the country on a path to become a high income economy. But its pattern has introduced new economic, social, environmental and external challenges that could ultimately slow growth and work against the stated goal of building a "harmonious society".

To become a high income economy by 2030, China will need to sustain relatively rapid GDP growth. However, three factors look set to contain growth going forward. First, the contribution from labor will decrease in line with lower and eventually negative expansion of the working age population. Second, the need to achieve more "intensive" and more balanced growth may require a gradual decline in the investment/GDP ratio, albeit to still very high levels. Third, the scope for TFP gains from rapid factor reallocation and the simple copying or transfer of technology will taper off as China approaches the later stages of industrialization.

In this setting, the key to sustaining relatively fast growth will be keeping the rate of increase of total factor productivity (TFP) near its past high rates, through policies and reforms to further improve economic efficiency. Within firm improvements in *technical efficiency* can be generated by technological innovation, better management, exploitation of scale economies, agglomeration economies linked to successful urbanization, and productivity improvements spurred by enhanced competition. Improvements in *allocative efficiency* would come through the movement of factors of production from lower to higher productivity uses (firms, sectors, locations). Better resource allocation would sustain the pace, alter the pattern, and boost the quality of growth. Such efficiency gains have been an important part of China's growth story to date, but are far from exhausted. To unleash such efficiency gains, China needs to move from a growth model appropriate for a period of "catch-up" to a one driven by efficiency and innovation. Building on modeling results, the report argues that sustained reforms could deliver growth rates which, while lower than those of the past three decades, will still allow China to join the group of high income countries by 2030.

However, as long recognized by China's leaders, growth is no longer enough. Simultaneously achieving a "harmonious society" will also require progress in making growth more equitable, environmentally sustainable, and balanced. Specific challenges include creating conditions for more employment generation and for improvements in the "primary income distribution", in the quality of and access to public services, in expanded social security and other means to reduce vulnerability, and in efforts to create a less resource-intensive form of growth.

Indeed, the report shows how concerted reforms to address key remaining distortions can put China on a development path which delivers both relatively fast growth and improvements in key social, environmental and external indicators. In contrast, such an outcome is inconceivable under broadly unchanged policies. In fact, an attempt to sustain the past growth model for an extended period could lead to a forced change in course as China finally reaches some of the limits of economic, social, environmental or external sustainability. Whether through a controlled change in policy or via a crisis, such a hasty shift would lead to sharply lower savings and investment rates, putting China on a slower growth path. This further strengthens the case for proactive reforms.

Such fundamental policy reforms will need to go hand in hand with increases in some categories of public spending. This has two implications. First, the fiscal system needs to be strengthened to help deliver the level and quality of public social, environmental, and infrastructural services deemed central to the vision of China 2030. Second, public resources will need to be raised efficiently and allocated such that rapid growth is maintained even as China approaches the technology frontier in a number of sectors. This is a bigger challenge than it may appear at first blush since many other constraints to growth—an anemic global economy, a shrinking and ageing labor force—also need to be overcome. This report argues they can be overcome through reforms in China's enterprise sector as well as in its input markets—land, labor, and capital.

1. **The fiscal system.** The large social and environmental agenda over the next two decades will entail significant expansion of social protection, health care, environmental public investment and recurrent expenditures, mostly by subnational governments. However, such increases will need to be achieved while maintaining fiscal sustainability, avoiding levels of taxation which could harm growth, easing the fiscal pressures on subnational governments, and strengthening fiscal institutions. Over the next two decades, then, the challenge will be six fold: (i) changing the composition and improving the efficiency of public expenditures in line with China's evolving development objectives; (ii) improving the efficiency of revenue mobilization; (iii) realigning revenues with expenditure responsibilities by raising selected functions to higher levels of government and allowing some governments to charge local taxes; (iv) bringing all subnational government borrowing and the associated spending on budget, subject to strict controls; (v) making sub-provincial transfers more equalizing across lower levels of government; and (vi) improving the accountability and transparency of governments.

2. **The enterprise sector.** A vibrant corporate sector will be critical for sustaining relatively fast growth. The central elements will be further increases in competition, especially (but not only) between the state and non-state (including private) enterprises in the "strategic" and "pillar" industries where such competition has been curtailed; and redefine the function of state capital and promote the securitization and trading of state capital, state capital should be used solely for the provision of public goods and services. This requires restructuring the SOE sector, dismantling monopolies and oligopolies in sectors where competition would yield superior results, introducing oversight arrangements where monopolies are considered necessary to ensure that market power is not abused and does not serve as a drag on the economy, and lowering entry and exit barriers for all enterprises. Improved allocative efficiency will also require further efforts to level the playing field, especially between smaller and larger firms, and between state-owned and non-state firms, not only in a legal sense, but also in the access to key inputs. The portfolio of SOEs should be diversified, some state shares should be sold in the market over time, and modern corporate governance practices should be exercised in SOEs. Finally, this will require a review and modernization of the extensive "industrial policies" which the authorities have used to influence the structure within and across sectors.

3. **The allocation of factors of production.** If anything, improving the efficiency in the use of factors of production—land, labor, capital—will be more challenging than reforming the enterprise sector. However, this is also the sphere in which many significant distortions remain, suggesting much potential from reforms to improve resource allocation.

In land, the principal challenges are to: (a) enhance rural land tenure security and ensure the equal treatment of rural and urban land tenure and property rights for social stability, particularly in rural areas; (b) modernize the institution of the rural collective to remain relevant in the face of evolving shifts in law and policy; (c) address the strict separation of rural and urban land tenure systems, which currently drives the inefficiencies and inequities generated by the process of converting rural land into urban use, by reducing the role of state in the land conversion process and by allowing for more market-based allocation of land; (d) ensure the protection of priority farmland for food security through comprehensive land use planning; and (e) introduce taxation of land and property to help ease the distortions and social pressures created by subnational governments' reliance on revenues from land transfer fees.

The financial sector faces three key reform challenges. First, there is a need to commercialize and rationalize the financial institutions and markets to meet the diverse demands of households, enterprises and government sectors for financial services and products. To this end, financial institutions should be better governed and operate in a conducive policy environment and under competitive pressure and effective regulation and supervision. Second, there is a need to modernize the regulatory architecture and to introduce a financial safety net, a task that has been made all the more difficult by the limited independence of regulatory authorities, the absence of an effective failure resolution regime, and the incentives faced by financial institutions. Third, the role of the government needs to be rationalized to enable it to focus on the critical functions of a public-good nature and to refrain from the direct provision of financing where the market forces could do better. This includes reform of the state-ownership functions over state-owned financial institutions.

A complementary report on human development addresses the issues of improving the flexibility and efficiency of labor markets in China, as many of the constraints and issues are interrelated with social protection and insurance.

These reforms are united by one common theme—"reforming government". For much of the last three decades, and unlike in high income countries, government has maintained a direct role in allocating resources, with instruments such as industrial policy and state ownership leading to tight interconnections between governments and enterprises. In contrast, in health, education, social security and other areas typically considered to require state involvement because of market failures, China's government had initially retreated. Traditional arrangements were abandoned and government spending lagged behind. The report identifies specific ways in which the role of the government can be recalibrated, generally towards a more limited direct role in resource allocation, a more arm's length relationship between government and business, and an enhanced role in delivering public goods and services and ensuring equality of opportunity. Reviewing the inter-relationships between various tiers of government will play a key role in this recalibration.

Chapter 1 Setting the Stage: China's Past Economic Performance, Key Challenges, and Future Growth Potential

A. Rapid Past Growth and its Sources

China's remarkable economic development over the last three decades has brought many positive results. Growth averaged 10 percent a year, far faster than in nearly any other country. This drove a parallel reduction of the poverty rate from 65 percent to well below 10 percent (World Bank, 2009a). As a result, China has become the world's second largest economy (accounting for 9.5 percent of global GDP in 2010), its largest exporter (with a global market share of over 16 percent and rising) and manufacturer, and an increasingly important engine of global growth.

As elaborated in Annex 1, China's fast growth over the last three decades can be explained from vaious perspectives. It was a type of growth characteristic of a catch up phase, where the combination of government-driven resource mobilization and pragmatic and effective market-oriented reforms allowed the country to exploit the "advantages of backwardness". Additional factors such as China's large market size, a "demographic dividend", the successful harnessing of globalization, and a large and disciplined workforce contributed to China's boom in manufacturing. Market-oriented reforms unlocked a vast pool of entrepreneurial talent, which further contributed to vigorous growth.

While the market mechanism was continuously expanded and now plays the lead role in resource allocation, the government has been playing a strong role during China's economic take-off. In general, the government used its regulations and powers in ways which favored the extensive input of capital and other factors for fast industrialization and urbanization. The Government's focus on expanding industrial investments helped to promote reallocation of factors from low productivity agriculture to higher productivity manufacturing. However, over time, the government's strong role, especially its influence on factor allocation, has contributed to ever more serious economic imbalances and social disharmonies. Going forward, this strong role can also be detrimental to improvements in technical efficiency, creative power and entrepreneurship at a time when China's growth will depend more on innovation.

B. The Emergence of Imbalances

This rapid growth and the accompanying structural change, while serving China well in many respects, also introduced new economic, social, environmental and external challenges that work against the government's stated goal of building a "harmonious society".[1] Spurred by high savings, cheap finance and other inputs, and export-oriented policies, China's growth has been investment- and industry-led. The priority accorded to industry stunted services development, while the emphasis on physical investment led to lower investment in human capital. In turn, highly capital intensive growth meant that China's economy created few jobs per unit of urban GDP growth.[2] With wages lagging productivity growth, the share of wage income in GDP declined to 48% by 2008, driving the share of consumption in GDP to unprecedentedly

[1] For a more extensive discussion of these imbalances, see the Summary Report of this series.

[2] Indeed, industrial employment grew by just 2.3% per year during 1993–2007, compared with annual value added growth of 11.7%.

low levels for any major economy. These trends contributed to high and widening income disparities, with overall measures of inequality approaching Latin American levels. Social imbalances were exacerbated by pronounced unevenness in access to public services, and by tensions surrounding land acquisition. On the environmental front, rapid growth, a shift in production towards more energy intensive industries, and urbanization, have combined to make China the world's largest energy user. Fast growth has also led to substantial natural resource depletion and serious environmental pollution. Finally, many of the policies that generated China's internal imbalances also contributed to its twin current and capital account surpluses. Together with China's expanding global market share, these fueled protectionist pressures in key foreign markets.

C. Avoiding the "Middle-income Trap" While Addressing Key Imbalances

To become a modern, harmonious, and creative high income society by 2030, China will need to (i) sustain relatively rapid growth while (ii) addressing the noted economic, social, environmental and global imbalances. In countries near China's level of per capita GDP, the first challenge is often termed that of avoiding the "middle income trap" (Gill and Kharas, 2007).

Two factors are set to contain China's growth rate going forward. The contribution from labor will decrease in line with lower and eventually (from around 2015) negative expansion of the working age population. Similarly, if some income will be transferred from enterprises to households to achieve social objectives or due to a tightening labor market, and if growth must become more "intensive" to meet environmental goals, the investment/GDP ratio could gradually decline, albeit to still very high levels.[3] In addition, somewhat lower investment rates will reduce the scope for the transfer of technologies embedded in new equipment. In any case, as China moves from a technological "catch-up phase" towards the frontier, a smaller share of productivity improvements will take such embedded form.

In this setting, the key to avoiding the "middle income trap" is keeping TFP growth near its past high rates, through policies and reforms to further improve the efficiency of China's economy. Without new impulses to raise TFP, growth could slow rapidly, exposing China's economy to heightened risks. Within firm improvements in *technical efficiency* can be generated by technological innovation, better organization and management, exploitation of scale economies (including from consolidation of supply chains), agglomeration economies linked to successful urbanization, and productivity improvements spurred by enhanced competition. Parallel improvements in *allocative efficiency* would come through the movement of factors of production from lower to higher productivity uses (firms, sectors, locations). Better resource allocation would sustain the pace, alter the pattern, and boost the quality of growth. As elaborated in Box 1, such efficiency gains have been an important part of China's growth story to date. However, they are far from exhausted and can be unlocked through further reforms.

[3] Investment rates would be supported by further reforms which work to sustain high rates of return to capital, by the large remaining scope for capital deepening, and by the new investment demand generated by emerging social and environmental challenges (Stern, 2011).

BOX 1 Factor reallocation has been a major contributor to productivity growth, but the potential for further gains remains significant

This conclusion is supported by several detailed studies of China's past performance. Hsieh and Klenow (2009) seek to measure the degree to which resource misallocation has lowered aggregate TFP in China and India. They model how distortions that drive wedges between the marginal products of capital and labor across firms will lower aggregate TFP. Using microdata, they find large gaps in marginal products of capital and labor across plants within narrowly defined industries in China compared with the United States. By hypothetically reallocating capital and labor to equalize marginal products to the extent observed in the US, they calculate potential manufacturing TFP gains of 50.5% in China in 1998. By 2005, these potential gains had been reduced to 30.5%, indicating progress in improving resource allocation in the intervening period as well as large remaining scope for further improvements.

Brandt and Zhu (2010) seek to quantify the sources of China's past growth. The authors consider three sectors: agriculture, the state part of non-agriculture, and the non-state part of non-agriculture. They find the increase in TFP in the latter sector as the key driver of growth. They also find significant misallocation of capital, with the less efficient state sector absorbing over half of all fixed investment, while representing only 13% of employment. The authors calculate that if capital had been allocated efficiently across the state and non-state sectors, with more going to the latter, China could have achieved the same growth without the observed increase in the rate of aggregate investment from 21% of GDP in 1978 to 40% of GDP in 2007. Looking forward, reducing distortions in capital markets could help China maintain relatively rapid growth while simultaneously reducing the imbalances between consumption and investment.

Bai, Hsieh and Qian (2006) also look at the dispersion of returns to capital across sectors, regions and types of ownership. They find clear evidence of misallocation but also some evidence that it may have lessened over time, thus contributing to China's growth performance. Bulman and Kraay (2011) find that factor reallocation has accounted for about 2.2 percentage points of growth over the period 1979–2008, or over one-half of the total growth in TFP. This contribution appears to have been on a declining trend.

China could formally reach high-income status with average GDP growth rates quite a bit below those it achieved over the past three decades. The threshold beyond which an economy is deemed to be "high income", "middle income", or "low income" is naturally arbitrary. However, the World Bank employs such thresholds for classifying its client members. Box 2 provides illustrative calculations of the growth rates needed to carry China to this "high income" threshold by 2030. As this marker itself is moving due to global growth, while the relevant Chinese growth rate is the product of domestic GDP growth and the evolution of the RMB/USD exchange rate, these calculations produce a range of estimates from 4% to 6.2%. Reaching a higher level above this very minimal threshold would require faster average growth; the average per capita income of high income countries is over 3 times this threshold level.

BOX 2 How fast will China need to grow to achieve high income status by 2030?

Between 1989 and 2009, the World Bank threshold between upper-middle-income and high-income countries grew by an average of 3.46 percent per year (nominal US dollars). Assuming that this threshold would continue to grow at the same rate, the benchmark in 2030 would be $24,079 per capita. To reach this level by 2030, China's GDP per capita in US dollars would have to grow at an average of 8.9 percent per year. Based on a projected population growth of 0.4 percent per year, this would require average GDP growth of 9.3 percent per year, in US $ terms. Assuming 2.3 percent US inflation, this would require 6.2 percent average real GDP growth if real exchange rate appreciation is 0.8 percent per year, and 4 percent average real GDP growth if real exchange rate appreciation is 3 percent per year.

Alternative assumptions about each indicator are easy to apply in this simple framework. For example, if the threshold were assumed to grow by around 4.5 percent per year instead of 3.5 percent, the required GDP growth rate would rise to 5–7.2%. Similarly, targeting a 2030 GDP per capita 10 percent above the formal high income threshold would require a 0.5 percentage point higher average growth rate.

Prominent projections of China's future potential growth bracket this range of growth rates, suggesting that high income status by 2030 is achievable. For example, Lin (2011) argues that China could still grow at around 8 percent per year over the next 20 years, based on a comparison with the performance of Japan, Republic of Korea and Taiwan (China) over periods when their per capita GDP relative to that of the US was similar to that of China today. In a recent multi-country review of growth performance, Eichengreen, Park and Shin (2011) project China to grow by 6.1 to 7.0 per year in the 2011–2020 decade and by 5.0 to 6.2 percent in the period 2021–2030. Finally, Lee and Hong (2010) forecast average growth over the period 2011–2030 of 5.5 percent under a "baseline" scenario and 6.6 percent under a "reform" scenario. Our own projections later in this section imply average growth of 6.6 percent over the next 20 years under a reform scenario, also suggesting that such a target is within reach.

However, growth is no longer enough. Simultaneously achieving a "harmonious society" will also require progress in making growth more equitable, environmentally sustainable, and balanced. Specific challenges include creating conditions for more employment generation and for improvements in the "primary income distribution", in the quality of and access to public services, in expanded social security and other means to reduce vulnerability, and in efforts to create a less resource-intensive form of growth.

This has long been recognized by China's top leaders. As a result, the need for a new growth model was made the paramount objective of all key government policy statements since the annual Central Economic Work Conference of December 2004.[4] The following year, they became an overarching thrust of the 11th Five Year Plan (5YP) 2006–2010. In a major shift from previous plans, where growth was the dominant objective, the 11th 5YP also emphasized environmental and social objectives. While some progress was made, the agenda is far from complete (World Bank, 2009c). These aims have now been maintained

[4] http://english.peopledaily.com.cn/200412/06/eng20041206_166239.html

and reinforced as central pillars of the 12th 5YP.[5] The need for more fundamental structural change to achieve such objectives has also long been stressed by many analysts of China's economy.[6]

D. Possible Scenarios to 2030

This understanding is also supported by the results of economic modeling, which deliver two strong messages. The first is a positive one. Concerted reforms to address key remaining distortions can lead China to a development path which delivers both relatively rapid growth and improvements in key structural, social, environmental and external indicators. Second, and in contrast, such an outcome is inconceivable under broadly unchanged policies. Under such a scenario, while growth could still remain relatively high, key social, environmental and external indicators would significantly worsen.

How might China's economy evolve over the next 20 years under a substantial further reform scenario? How high could trend growth be given the fundamentals? How would the structure of the economy evolve? To examine the impact of different long-run strategies on the speed and quality of China's future growth (including on resource use, income inequality and the external balance), the Development Research Center (DRC) has updated its Computable General Equilibrium model, which incorporates the detailed structure of production, demand, income distribution, and resource use in China to conduct illustrative alternative long-term scenarios.[7,8]

A reform scenario which assumes substantial policy reform along the lines sketched out in the report is first developed and quantified. We then consider alternative more qualitative scenarios where such reform is not forthcoming or is of lower quality.[9]

Under the modeled reform scenario, overall GDP growth would slow over time, but still to rates which could ensure high income status by 2030. All main drivers of growth evolve gradually. While more employment-friendly labor market policies and more labor-intensive

[5] Under the 12th 5YP, these gained added relevance due to changes wrought by the global financial crisis. With subdued medium-term prospects for the global economy—and thus for exports—China will need to generate more growth from domestic demand if it is to sustain relatively high rates of overall GDP growth.

[6] For example, see Kuijs and Wang (2006), Blanchard and Giavazzi (2006), Lardy (2007), and Aziz and Dunaway (2007).

[7] The DRC-CGE model (2012 edition) includes 34 production sectors; 2 representative households distinguished by area; and 4 primary production factors: capital, agricultural labor, productive workers, and professionals. The 34 production sectors include 1 agricultural sector, 24 industrial sectors, and 9 services sectors. For a detailed description of model, see Shantong Li *et. al.,* "Simulated Scenarios for China's Economic Growth: 2011–2030", China Economist, May–June 2010 and He and Kuijs (2007). This study has updated the previous simulations by incorporating new economic data and adjusting some parameters in light of new empirical research.

[8] The main drivers of growth are technological progress, demographics, capital accumulation. In this model, technological progress is exogenous and calibrated according to China's historical data and international experience. In addition, the growth rate of population and labor is exogenous. The growth rate of capital is determined endogenously by the savings/investment relationship. In this model, the basic factor driving structural change are the income demand elasticity of residents for different commodities (the Engel effect), the structural change of intermediate input demand resulting from technological change, and factor composition change resulting from different factor accumulation speeds.

[9] These scenarios are not meant to be precise, detailed investigations of the future. Rather, they are somewhat stylistic, based on analysis of how key macroeconomic variables have related to each other in the past and assumptions on how these relationships may evolve in the coming 20 years. Many of those assumptions unavoidably have an arbitrary element.

production allow employment to grow slightly faster than the working age population, demographic factors still cause employment to begin shrinking around 2015. With the beneficial impact of opening up the economy and integration into the world economy expected to phase down, with China moving closer to the technological frontier, and with declining potential to remove distortions, TFP growth edges down over time, although to a still high level by regional standards. Finally, the contribution of capital accumulation to growth also declines but remains sizeable. Restructuring the economy takes time, while the need remains for high levels of manufacturing activity and for further investment, notably in infrastructure but also towards industrial upgrading. The capital stock per worker is now an estimated 8.7% of the US level, underscoring the need for further capital accumulation. GDP growth would gradually decline from an average of 8.6% in 2011–2015 to an average 5% in 2026–2030.

Such a growth slowdown would be independent of policies to transform the economic development pattern. Relative to an alternative "on past trends" scenario described below, this scenario features significantly lower investment, hence a smaller contribution from capital accumulation. However, this effect would be broadly offset by still high TFP growth, driven by factors such as more reallocation of labor (both across firms and from rural to urban areas), more financial sector reforms, better corporate governance, fewer distortions and barriers to services sector activities, more R&D, and more development of human capital.

Over a 20 year horizon, this scenario also sees significant changes in the structure of the economy, supporting a reduction of economic, social, environmental and external imbalances. Key specific trends include:

- **The importance of industry declines and that of the service sector rises.** The share of industry in GDP gradually declines by 12 percentage points from 46.8% in 2010 to 35% in 2030, while that of the tertiary sector rises by a significant 18 percentage points from 43% in 2010 to 61% in 2030.

- **The share of consumption in GDP rises from 47% in 2010 to 66% in 2030, reversing the past steady decline.** Reforms which encourage urban job creation and greater upward pressure on wages boost the share of wages and household income in GDP, increasing the role of household consumption. Government consumption rises on the back of increasing social spending and spending on operations and maintenance.

- **Investment as a share of GDP declines over time.** This ratio trends down by 15 percentage points to a more sustainable 34 percent in 2030, well below both current levels and levels under any alternative "on past trends" scenario. Despite lower investment, the current account surplus gradually declines over time, as a share of GDP, easing external imbalances.

- **The economy creates more urban jobs and, as a result, more rural-urban migration, higher rural productivity and income, and less urban-rural inequality.** More urbanization stimulates the service industry, including via the spending patterns of urban residents. The share of employment in agriculture falls to 12.5% in 2030.[10] This works to support the growth of

[10] This may seem fast. However, it is not out of line with experiences in other South East Asian countries. South Korea witnessed a faster pace, from 50 percent in 1973 to 10 percent in 2001. Malaysia decreased its agricultural employment share from 37 percent in 1980 to 18.4 percent in 2001.

TABLE 1 China: Projected growth pattern assuming steady reforms and no major shock

Indicator	1995–2010	2011–2015	2016–20	2021–25	2026–30
GDP growth (percent per year)	9.9	8.6	7.0	5.9	5.0
Labor growth	0.9	0.3	−0.2	−0.2	−0.4
Labor productivity growth	8.9	8.3	7.1	6.2	5.5
Structure of economy (end of period, %)					
Investment/GDP ratio	46.4	42	38	36	34
Consumption/GDP ratio	48.6	56	60	63	66
Industry/GDP ratio	46.9	43.8	41.0	38.0	34.6
Services/GDP ratio	43.0	47.6	51.6	56.1	61.1
Share of employment in agriculture	38.1	30.0	23.7	18.2	12.5
Share of employment in services	34.1	42.0	47.6	52.9	59.0

Source: DRC.

labor productivity in agriculture, hence income growth in that sector. The decrease in the productivity gap between agriculture and the other sectors would underlie lower urban-rural income inequality.

- **China uses fewer primary commodities and energy and produces less pollution.** This is because it has less industry and, within industry, less heavy and dirty industry, in large part because of better pricing of energy, commodities, and environmental degradation.

Alternative scenarios are possible. Differences in global developments would naturally affect China's prospects. As the resulting possible range of domestic exogenous and policy scenarios is vast, we discuss the key features of such alternatives in more qualitative terms.

One alternative domestic scenario would see much less progress with economic restructuring. Under this "on past trends" scenario, policy settings and trends would remain broadly unchanged. As a result, factors and resources would continue to be channeled towards industry, with the share of industry in GDP edging down only slightly between 2010 and 2030. The share of services would still increase, but to a low level compared to countries at a similar stage of development. Already very high investment and savings would increase further and already very low consumption would decline further. Overall, the current account surplus would remain high despite increasing levels of investment. Labor migration out of agriculture and urbanization would continue, but at a slower pace. More modest urban job creation would limit the increase in the household income share, while the labor productivity gap between agriculture and the rest of the economy would remain high. Both factors would further accentuate urban-rural income disparity and overall inequality. Finally, in this industry-led scenario, energy and resource intensity would remain high and pollution and emissions would continue to rise.

In fact, continuing with the past pattern would become increasingly difficult, if not impossible. While the described "on past trends" scenario can be modeled, a more likely outcome would be a future forced change in course as China finally reaches some of the limits of economic, social, environmental or external sustainability.[11] Whether through a controlled change in policy or via a crisis, such a hasty shift would lead to sharply lower savings and investment rates, putting China on a slower growth path than under the reform scenario. This further strengthens the case for up front reforms to get China on a new growth path.

[11] Such limits could include declining margins in the production of tradable goods, excess capacity, asset bubbles, insufficient employment generation, environmental degradation and trade protectionism.

Chapter 2 Promoting Efficiency and Equity through Structural Reform: From Catch-up Growth to Endogenous Development

A. Changing the Role of the State

To achieve its vision for 2030, China needs to shift from factor input-driven to efficiency-driven growth, from direct state intervention to more reliance on markets and entrepreneurship, and from the absorption of technologies to innovation, while simultaneously correcting economic imbalances and social disharmonies. Doing so will require a sense of the policy areas which offer particular promise for promoting rapid and harmonious development, and the specific reforms which would be required. This report now turns to examining such issues. It argues that these reforms will need to focus on three broad areas which promise particularly significant gains in efficiency or reductions in imbalances. First, the enterprise sector needs to be further reformed to facilitate more efficient resource use and motivate innovation and entrepreneurship. Second, reforms of input markets—land, labor, and capital—need to be advanced to rectify distortions in factor allocation.[12] Third, the fiscal system needs to be improved to help sustainably deliver the level and quality of public social, and environmental services central to the vision of China 2030. The remaining resources available for investment will need to be raised and allocated such that rapid growth is maintained even as China approaches the technology frontier in a number of sectors.

These reforms are united by one common theme—"reforming government". For much of the last three decades, while the market mechanism has been demonstrating its effective function in allocating resources and spurring economic growth, the government has maintained a direct role in allocating resources and deciding business affairs. It does this by maintaining significant ownership stakes in some important enterprises in "strategic" sectors and deploying a range of industrial interventions to influence resource allocation. It also exercises complicated regulations and oversight to channel factors at low cost into industrialization and urbanization. In contrast, in health, education, social security and other areas typically considered to require government involvement because of market failures, China's government had initially retreated. Traditional arrangements were abandoned and government spending lagged behind. Also many public entities such as hospitals and schools had to "fend for themselves", becoming responsible for their own revenue generation.

China's strong track record under the existing policies, especially its relatively good performance during the recent global crisis, is no reason to avoid reforming government. China's past success was the combined result of market and government forces and actions. A strong government used direct interventions to push forward industrialization and urbanization, to overcome market failures and to facilitate factor accumulation while the market unleashed the power of the enterprise sector. As described by economists like Gerschenkron (1962) and Rosenstein-Rodan (1961), such policies to reap the "advantages of backwardness" are not unusual. However, as China approaches the general technological frontier and finds it harder to sustain an extensive form of growth, this previous advantage can become the disadvantage. Over time, specific incumbent enterprises can solidify their privileged access to resources and government support. In China, many such firms are larger SOEs, as SOEs are naturally connected to the government and often seen as strategically important. This biased business environment can jeopardize fair competition, efficiency improvement and innovation, and be harmful for an economy

[12] A companion volume looks at the other policies needed to advance the pace of innovation, a critical ingredient for rapid growth by improving China's technological capability and moving up the value chain.

to complete its industrialization and join in the club of high-income countries. The economic imbalances and social disharmonies will also become more and more difficult to handle.

To achieve rapid sustained growth driven by efficiency and innovation, the report identifies specific ways in which the role of the government and its relationship with enterprises can be recalibrated, generally towards a more limited direct (more arm's length) role in resource allocation and an enhanced role in delivering public goods and services and ensuring equality of opportunity. As economic development progresses, markets function increasingly well, and the economy becomes increasingly sophisticated, the benefit of direct government involvement in allocating resources weakens. In this connection, it is useful for China to review the role of government in input markets, in state ownership of companies, and in industrial and competition policies. On the other hand, in line with the aim to become a harmonious society, there is scope for more government involvement in health, education, and social security. Reviewing the inter-relationships between various tiers of government will play a key role in this recalibration.

B. From Catch-up Growth to Endogenous Development

Government reform will be crucial for helping China move from its previous catch-up growth approach to a more endogenous development approach. So far, this has proven very challenging. While a 2003 CPC plenum vowed to transform the government's function in economic management (especially through reform of the administrative approval and investment systems), limited progress has been made. Going forward, such progress in government reform will be promoted by reform of the fiscal system, the enterprise sector reform and factor allocation.

1. **The fiscal system.** The large social and environmental agenda over the next two decades will entail significant expansion of social protection, health care, environmental public investment and recurrent expenditures, mostly by subnational governments. However, such increases will need to be achieved while maintaining fiscal sustainability, avoiding levels of taxation which could harm growth, easing the fiscal pressures on subnational governments, and strengthening fiscal institutions. Over the next two decades, then, the challenge will be six fold: (i) changing the composition and improving the efficiency of public expenditures in line with China's evolving development objectives; (ii) improving the efficiency of revenue mobilization; (iii) realigning revenues with expenditure responsibilities by recentralizing some selected functions and allowing some subnational governments to charge local taxes; (iv) bringing all subnational government borrowing and the associated spending on budget, subject to strict controls; (v) making sub-provincial transfers more equalizing across lower levels of government; and (vi) improving the accountability and transparency of governments.

2. **The enterprise sector.** A vibrant corporate sector will be critical for sustaining relatively fast growth. A central element will be further increases in competition, especially (but not only) between the state and non-state (including private) enterprises in the "strategic" and "pillar" industries where such competition has been curtailed. This requires dismantling monopolies and oligopolies in sectors where competition would yield superior results, introducing oversight arrangements where monopolies are considered necessary to ensure that market power is not abused and does not serve as a drag on the economy, and lowering entry and exit barriers for all enterprises. Improved allocative efficiency will also require further efforts to level the playing field, especially between smaller and larger firms, and between state-owned and non-state firms, not only in a legal sense, but also in the access to key inputs. Finally, this will require a review and modernization of the extensive "industrial policies" which the authorities have used to influence the structure within and across sectors.

3. **The allocation of factors of production.** If anything, improving the efficiency in the use of factors of production—land, labor, capital—will be more challenging than reforming the enterprise sector. However, as shown in Box 3, this is also the sphere in which many significant distortions remain, suggesting much potential from reforms to improve resource allocation.

In land, the principal challenges are to: (a) enhance rural land tenure security and ensure the equal treatment of rural and urban land tenure and property rights for social stability, particularly in rural areas; (b) modernize the institution of the rural collective to remain relevant in the face of evolving shifts in law and policy; (c) address the strict separation of rural and urban land tenure systems, which currently drives the inefficiencies and inequities generated by the process of converting rural land into urban use, by reducing the role of state in the land conversion process and by allowing for more market-based allocation of land; (d) ensure the protection of priority farmland for food security through comprehensive land use planning; and (e) introduce taxation of land and property to help ease the distortions and social pressures created by subnational governments' reliance on revenues from land transfer fees.

The financial sector faces three reform challenges too: (a) to commercialize and rationalize the financial institutions and markets to meet the diverse demands of households, enterprises and government sectors for financial services and products. To this end, financial institutions should be better governed, operate in a conducive policy environment and under competitive pressure and effective regulation and supervision; (b) to modernize the regulatory architecture and to introduce a financial safety net to ensure smooth functioning of the financial system, a task that has been made all the more difficult by the lack of independence of the regulatory authorities, the absence of an effective failure resolution regime, and perverse incentives of the financial institutions; and (c) to rationalize the role of the government to enable it to focus on the critical functions of a public-good nature and to refrain from the direct provision of financing where the market forces could do better; and to ensure the state-ownership functions are strengthened over state-owned financial institutions.

A complementary report on human development addresses the issues of improving the flexibility and efficiency of labor markets in China, as many of the constraints and issues are interrelated with social protection and insurance.

BOX 3 Where are the largest remaining distortions in product and factor markets?

In a series of recent papers,[13] Yiping Huang and collaborators show that China's specific reform approach has led to extensive liberalization of product markets, with prices of over 95% of products being market-determined, but left continued distortions in factor markets. The authors focus on labor, capital, land, resources and the environment. They present crude estimates of the cost of remaining distortions in each area, with particularly high measures for capital and labor. Such distortions acted like implicit subsidies and artificially raised the profits of production, increased returns to investment, and increased China's external competitiveness. While such asymmetric liberalization was a fundamental cause of China's extraordinary growth performance, it also contributed to the observed growing structural (including global) imbalances and risks. Future efforts should focus on comprehensive market-oriented reform of factor markets.

Similarly, Chen, Jefferson and Zhang (2011) investigate the impact of structural reform during the period 1980–2008 using the input-output panel of 38 two-digit industrial sectors in China. They find that, on average, factor allocative efficiency plays a substantial role in industrial growth by increasing productivity. Based on their analysis, the most urgent reforms are to continue the development of factor markets (including by providing non-state enterprises equal access to resources and developing non-state financial institutions) and to deepen the restructuring of state industry.

Zhang and Tan (2007) examine and estimate the changing patterns of distortions during the reform process. They find that China's product markets have become more integrated after an initial period of fragmentation in the early reform period. The large shift from farm to non-farm employment and relaxed constraints on migration also indicate increased labor market integration. However, inter-sectoral differences in marginal product of capital have grown during the reform period, suggesting remaining distortions concentrated in financial and land markets.

[13] Huang (2010), Huang and Tao (2010) and Huang and Wang (2010).

While discussed individually here, reforms of the fiscal system, the enterprise sector and factor allocation are highly interrelated. For example, incentives created by the fiscal system influence the form of industrial policy, particularly the actions of local authorities. The differential access to finance of various enterprises influences China's industrial structure. The ability of governments to capture the rents created by China's dualized system of rural and urban land impact on the structure of government revenues and expenditures. Especially during crises, limits of the fiscal system have encouraged governments (including subnational governments more recently) to employ the financial sector as a quasi-fiscal tool to support state enterprises and public and social infrastructure. As a result, the banking system has needed to be periodically recapitalized, with fiscal repercussions. Thus, making the fiscal system stronger is a critical element of making the financial sector more competitive and commercial.

Such reforms must also be carefully sequenced. While the following chapters provide specific suggestions on the sequencing of reforms within a given area, there also some general lessons for sequencing across broad areas of policy. First, in the most general terms, enterprise reforms should precede financial sector reforms. This is because a liberalized financial sector channeling resources to a still distorted enterprise sector could in fact exacerbate distortions in resource allocation and raise risk levels. In contrast, once major price and other distortions have been removed, once enterprises have begun to face a truly hardened budget constraint, and once important source of moral hazard have been addressed, the financial sector will be much better placed to allocate capital in line with its social rate of return. Of course, this does not mean that all financial sector reforms should be delayed. In fact, it places a premium on early action to strengthen regulation and supervision, enhance commercialization and gradually lower floors on lending rates and raise ceilings on deposit rates within a still controlled setting.

In broad terms, fiscal reform should move in tandem or even slightly in advance of enterprise sector reforms. Remaining tax distortions and incentives created by the system of intergovernmental finance are combining with other policies to distort China's industrial structure. Remaining weaknesses in the fiscal system have forced the reliance on off-budget borrowing by local governments, further distorting resource allocation and raising risk levels. Thus, a frontloading of fiscal reforms, particularly in the spheres of revenues (especially the channeling of SOE dividends to the budget) and local borrowing could create conditions for more effective enterprise and financial reform.

The rest of the report examines four specific areas where policy reform will be crucial for achieving China's 2030 vision. In each of these areas, what is the vision for 2030? What progress has already been made and what are the key current challenges in getting on a critical path for achieving the vision? What more specific steps should be taken in the near-, medium- and longer term? The report highlights key points which are elaborated in more detail in longer background papers.

Chapter 3 Strengthening Fiscal System

A. Fiscal System Reform in Line with the Evolving Role of the State

Fiscal policy is a key determinant of efficiency and equity, and thus of China's ability to achieve its 2030 vision. By efficiently mobilizing and spending around 30 percent of GDP, government can increase the availability of crucial public goods and services, address key externalities, and support increases in overall efficiency. Tax policies have indirect incentive effects on the savings, investment and consumption decisions of firms and households. Government also has a central role in reducing inequalities in opportunity and maintaining macro and financial stability. Well designed fiscal reform can help sustain rapid growth, address important social gaps, and make the development path more environmentally friendly.

Over the past two decades, China has greatly reformed its fiscal system. A major overhaul in 1994 focused on enhancing revenue mobilization and revamping national-provincial fiscal relations. A new tax system with the value-added tax as its core laid the foundations for a significant growth in the revenue to GDP ratio. This allowed China's public spending to grow to levels comparable with other economies with similar incomes, bringing significant improvements in public goods and services. The reform also launched important changes in China's system of inter-governmental fiscal relations. Changes in tax assignments significantly strengthened the central government's revenue base, laying the foundation for greater and more rules-based transfers to begin tackling fiscal disparities. This was followed by further incremental reforms in a range of areas. Fiscal policies also played an active role in China's industrialization. For instance, China successfully attracted foreign investment through preferential tax treatment and other incentives provided by subnational governments.

Looking forward, by 2030 China will need a financially strong and effective fiscal system capable of meeting the economic, social, and environmental needs of a complex and sophisticated economy. In particular, as outlined below, the government would have to meet increasing demands for public goods and services, an expanded social safety net and improvements in human capital. Despite China's substantial existing fiscal space and major untapped sources of fiscal revenues, the scale of looming expenditure pressures combined with the lessons provided by the ongoing sovereign debt problems of several developed regions attest to the importance and difficulty of maintaining fiscal sustainability. Fiscal costs need to be honestly estimated when initiating new social programs, and containment of some expenditures should be considered. In addition, fiscal system reform will be a key instrument for recalibrating the role of the state and strengthening governance and self-regulation to meet China's emerging challenges. Such reforms would focus on provision of public goods and services including regulatory institutions, and on providing appropriate incentives for sub-national governments to carry out their functions in a financially sustainable and operationally self-disciplined manner. Over the next two decades, successful reform and institutional strengthening would fundamentally transform China's fiscal system in five important dimensions:

1. The *composition of spending* would be different from what it is today, reflecting changes in the function of government as China attains higher income levels, places greater emphasis on social and environmental outcomes, and faces the need to operate and maintain its rapidly growing stock of infrastructure.
2. Most remaining distortions in *the revenue system* would have been addressed with a view to improving efficiency and/or equity, with several currently minor or non-existent revenue sources (e.g. carbon taxes, personal income taxes, SOE dividends) playing significant roles in both mobilizing on-budget revenues and addressing key distortions.
3. While public spending may or may not play a larger role in the economy than it does today, the relative *levels of spending and revenue* would be in line with macroeconomic stability,

balancing the tensions arising from pursuing the dual objectives of rapid growth and greater social and environmental sustainability.

4. *Inter-governmental fiscal arrangements* would be better balanced, both vertically (between levels of government) and horizontally (across jurisdictions), especially at the sub-provincial level. This would promote the adequate provision of local infrastructure, social protection and basic public services.
5. A significant strengthening of budget system institutions (including full consolidation of spending and revenues) would have greatly enhanced *accountability and transparency* and improved budget planning and execution at all levels of government, and improved the effectiveness of government.

This report argues that such a transformation can be achieved through a continuation and deepening of the fiscal reforms which China has pursued over the past decades. Past and present policies have been broadly appropriate given the challenges of the time, and much has already been accomplished. However, more remains to be done to complete the reform agenda, to align with evolving challenges, and to benefit from past improvements in institutional capacity. Within each of the five priority areas, the report explores policy options and tools which could be useful for China to manage its new challenges and contain emerging risks.

B. China's Fiscal System—Key Developments to 2010

Government spending has supported the country's development strategy and has evolved in response to changing development objectives. Expenditures heavily tilted towards physical investments supported rapid growth in a "catch up" phase during which the removal of physical bottlenecks offered high rates of return. While off-budget investment by local governments obscures the size and composition of such investments, total public spending on infrastructure is estimated to have reached over 10% of GDP (Liu, 2010), as compared with 3–4% in many other developing countries. More recently, spending has begun to be shifted toward promoting equity and more balanced growth, in line with China's development strategy outlined in the 11th 5YP. To this end, the government has expanded its network of social protection (e.g. urban and rural minimum income support, rural medical cooperative scheme, and medical assistance for the poor; central transfers to expand rural education), increased expenditures on rural areas and agriculture, abolished agricultural tax, significantly narrowed the fiscal disparities across provinces through transfers, and improved provision of public services.

A large share of government spending has been for "economic activities", while gaps in core public services such as health and social protection remain significant. According to IMF Government Finance Statistics, total general government spending reached 25.7 percent of GDP by 2008.[14] As Table 2 shows, China's public spending on social protection and health as a share of GDP is well below OECD and upper-middle income country averages. If such spending is excluded, the remaining non-redistributive government spending is comparable with that in OECD countries. This reflects the active role of China's government in economic activities, including subsidies to firms and infrastructure spending. Part of infrastructure spending is financed by revenues from the sale of land use rights which are (correctly) excluded from the aggregates noted above but now subject to budgetary oversight. However, a more significant amount of investments is funded through borrowing by local Urban Development Investment

[14] This compares to headline budgetary government size of 19.9 percent of GDP in 2008 (22.5 percent in 2010). The GFS data is a broader measure, which includes government activities funded by some government funds and the social protection fund. As in other countries, these funds are separate from the core central budget. Nonetheless, they are subject to budget-type planning and management, and sometimes presented as part of a broader definition of consolidated spending. The budget preparation cycle for such funds is increasingly being aligned with that of the core budget.

Corporations (UDICs) whose activities are off budget by definition. Adding their expenditures would raise it the above around 30 percent of GDP in 2008.[15] While an active government role in resource allocation is appropriate in the catch up phase of development, this role should shift towards the core business of government—provision of public goods and services—as China enters a more advanced stage of development.

On the revenue side, a series of reforms have addressed many past distortions. These include unifying the corporate income tax (between domestic and foreign funded enterprises), shifting from a production based to consumption based VAT, lowering import tariffs, raising the threshold for personal income taxes and introducing a fuel tax.

Improved revenue collection allowed spending to grow without compromising macro stability. Headline budgetary revenues rose from less than 10 percent of GDP in the mid-1990s to around 20 percent of GDP today. The government also raises some 2 percent of GDP through "government funds" other than land revenue and about 4 percent of GDP through social protection contributions. In addition, sub-national governments raise significant revenues from land assets and borrowing via UDICs, which have mainly been used to support land development and infrastructure investment.[16] The resulting modest fiscal deficits and reported government debts also allowed the government to effectively cushion the negative shock from the recent global financial crisis.

TABLE 2 Size and composition of public expenditures, cross country comparison, as percent of GDP

Percent of GDP /*	High Income	Middle Income		China
	OECD	Upper Middle	Lower Middle	
Total Outlays	41.6	33.1	36.1	25.7
General public services	5.6	5.6	5.5	2.9
Defense	1.6	1.5	2.2	1.3
Public order and safety	1.6	2.0	2.6	1.3
Economic affairs	4.2	5.3	6.1	7.9
Environment protection	0.7	0.5	0.3	0.5
Housing and community amenities	0.8	1.2	3.0	1.9
Health	6.3	3.3	3.1	1.0
Recreation, culture and religion	1.2	0.8	1.0	0.5
Education	5.4	3.9	5.4	3.7
Social protection /**	15.2	9.0	6.9	4.7
Memo: total outlays excluding health and social protection	20.1	20.8	26.2	20.0

Sources: GFS, WDI and World bank staff estimations.
/* Data about all the countries are in 2007 except data about China is in 2008.
** China's Social protection includes both outlays to pension fund and to health insurance. Adding those financed from general budget, the total public expenditure on health totals around 2.5% of GDP in 2008.

The recentralization of revenues in 1994 strengthened the central government's capacity to redistribute in favor of poorer provinces. Net transfers from the center make up an increasing share of subnational government resources (Table 3). Among transfers, both general equalization grants and earmarked transfers (targeted at specific development priorities) have been growing in recent years, allowing a welcome phased reduction of the "transitional systems transfer". Viewed at the provincial level, such transfers have vastly reduced if not removed the correlation between government expenditure per capita and the level of local economic

[15] This has risen to over 35% of GDP in 2010.
[16] According to Ministry of Finance (2011), the gross revenue from the sale of state owned land use rights rose to 2.9 trillion RMB in 2010, equivalent to 7.3% of GDP. As a substantial share of such revenues is paid out in the form of compensation to displaced residents, the net proceeds from such sales are lower but still significant.

development. The difference in expenditure per capita across provinces can be largely explained by factors that affect the delivery cost, including average wage and population density.

Finally, the efficiency of public expenditures has been improved through a range of measures to strengthen public financial management. Most extra-budgetary charges have been abolished or brought on budget, and plans are in place to bring the remainder on budget. As in many countries, while social security contributions and revenues from sale of land use rights and other government assets flow to separate funds, these have all been subject to budget type management, and a more comprehensive view of public finances is emerging.[17] Dividends from SOEs have begun to grow, have been brought into a separate capital operating budget, and are gradually becoming available to finance the general budget. Single treasury accounts have been broadly established at the central and provincial levels and are being rolled out at lower government levels, laying the basis for enhanced monitoring and control of budget execution. Government accounting reform with improved classification of government activities made a strong foundation for improving transparency. Performance evaluation has been piloted in selected programs.

TABLE 3 Subnational government finance

	1996		2001		2008		2009	
	bil yuan	%	bil yuan	%	bil yuan	%	bil yuan	%
Budgetary expenditures	578.6	100	1313.5	100	4924.8	100	6104.4	100
Budgetary revenues	374.7	64.8	780.3	59.4	2865.0	58.2	3260.3	53.4
net transfer from center	211.9	36.6	541.1	41.2	2204.4	44.8	2856.4	46.8
ow. General transfer	15.9	2.7	121.5	9.3	874.6	17.8	1131.7	18.5
Earmarked transfer	48.9	8.5	223.7	17.0	996.7	20.2	1236.0	20.2

Data sources: MOF and staff calculation

C. Challenges and Policy Options for Strengthening China's Fiscal System

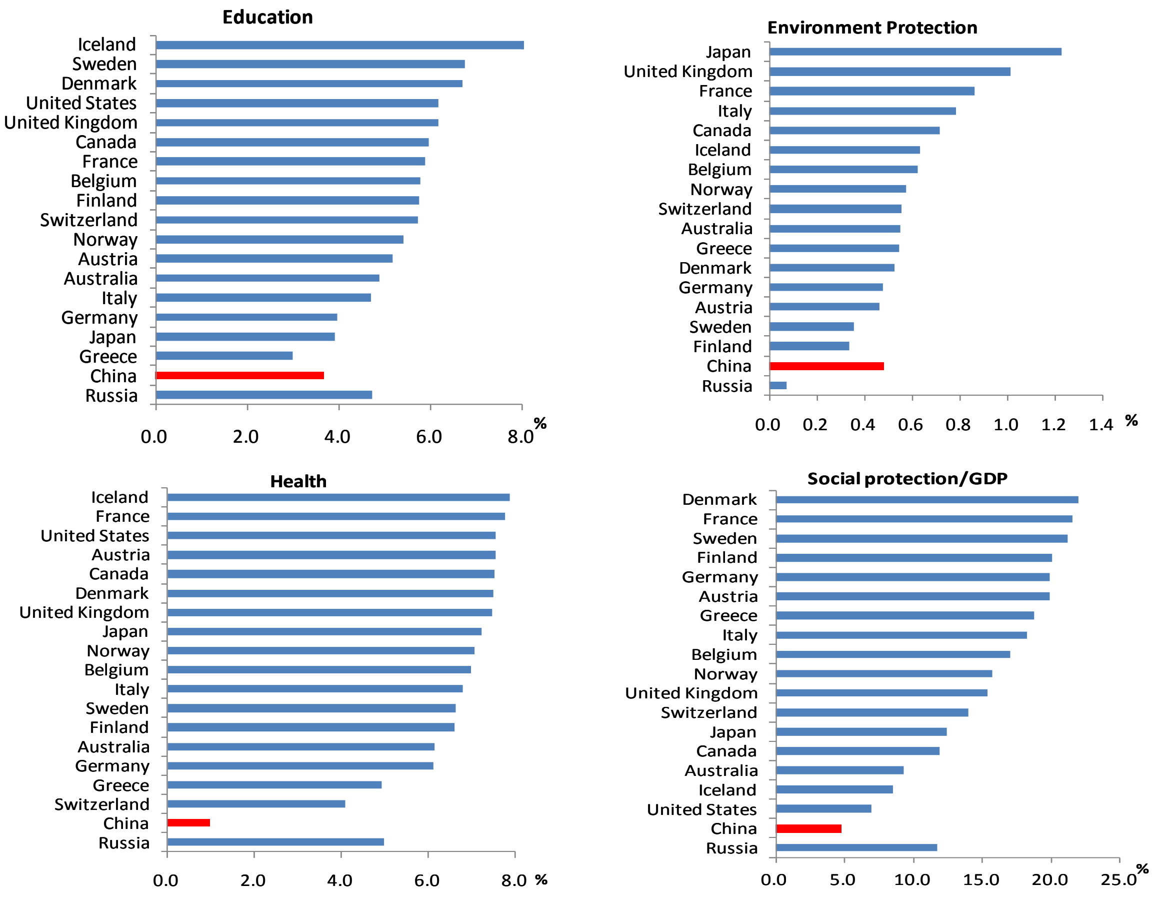
The long-term vision and current starting point elaborated above imply a clear direction for fiscal reforms over the next two decades. In most aspects, the broad direction is understood by policymakers and related programs have been included in the 12th 5YP. Within each of the five noted dimensions, this section highlights more specific areas which offer the greatest challenges as China seeks to get on a path to achieving its vision. Drawing on international benchmarking and experiences, it also suggests policy options and tools that could be applied in China.

1. Restructuring government expenditures

The composition of government spending needs to evolve to reflect China's changing development challenges as it transitions to high income status. Most notably, providing social security and a basic set of public services, and building human capital and expanding opportunity will require additional spending on health, social protection and environmental protection. As shown in Table 2, China's public spending on social protection and health as a share of GDP is significantly below average levels in OECD and upper-middle income countries. The gap in

[17] In 2004, MOF released a list of Government Funds, stipulating that no government agency was allowed to charge fees beyond this list. In 2010, the State Council began compiling a national budget for social security funds on a trial basis. This budget initially included funds for five types of social security: basic old-age insurance, unemployment insurance for enterprise employees, basic medical insurance, workers' compensation, and maternity insurance for urban workers. The eventual aim would be to bring other social security funds within the control of the national budget. From 2011, the Provisional Rule on Government Funds Management includes a stipulation that all government funds revenues should be included in the fiscal budget and subject to the scrutiny of NPC.

FIGURE 1 Cross-country comparison of government expenditures as a share of GDP



Sources: Government Finance Statistics (2007, 2009), and staff estimation.

education spending is quite a bit smaller. While China's reported spending on environmental protection appears in line with OECD and upper-middle income country norms, the significant backlog and new challenges in this area could well require a further scaling up of such expenditures.

There is no uniform high income country model for the size of such expenditures relative to GDP, especially for social and environmental protection. High income countries tend to spend more on these items than middle income countries, but with much variability. Figure 5 benchmarks China's spending on these four items against a range of OECD countries and Russia. For example, the share of public spending on health in GDP ranges from 4.1 percent in Switzerland to 7.9 percent in Iceland, and the share of social protection ranges from 7 percent in the United States to over 20 percent in Denmark and France. The overall cost will much depend on the level of protection and the scheme design, which is ultimately a political decision of the country. Also, given the fiscal problems currently faced by many advanced economies, their current spending levels should not be compared very mechanistically.

Using these and other international benchmarks as reference, China could potentially aim to increase public expenditures by 2–3 percentage points of GDP for health care, and another 3–4 percentage points to fully finance the basic pension pillar and to gradually meet the legacy costs of existing pension obligations. These add up to an incremental fiscal outlay of around 7–8 percent of GDP—which is a reasonable estimate to bring China's aggregate "social expenditures" by 2030 to near the lower end of the range of high-income countries. Going forward, China will also need to allocate more resources to operating and maintaining its rapidly growing stock of physical infrastructure assets.

While infrastructure investment may need to be scaled back in the longer-term, these and other expenditure reallocations need not be linear. In the short to medium term, still rapid urbanization and further integration of the national market could demand more infrastructure investment. The further rise in household income would correspondingly increase the financial and economic return to infrastructure, justifying such investments. Over the medium to long term, as the infrastructure stock has been built, the marginal rate of return to infrastructure assets could begin to decline. By that time, public investment could be more rapidly phased down towards levels observed in higher income countries, leaving more resources for other activities.

BOX 4 Functional reviews: a tool for designing reforms for a more efficient government

Functional reviews offer a flexible, problem driven and evidence based framework that can help public sector organizations at various levels to identify key performance constraints, analyze the functions they perform, assess their relevance and draw recommendations for organizational and process changes to enable more effective delivery. It typically evaluates existing expenditure programs along two dimensions: efficiency and effectiveness. Such reviews vary by objectives and scope. In some cases, the focus is at the policy and program level on effectiveness concerns; in other cases the focus is at the organizational level on efficiency concerns or a combination thereof.

Functional reviews have been applied in many countries. In **Canada,** a 1994 program review established a high level special committee under the Prime Minister. The Committee set performance based guidelines and managed the review process that helped to generate substantial cuts (averaging 21.5 percent across departmental budgets). In **New Zealand**, an expert based, top-down review of the state sector was undertaken without the participation of line agencies. Restructuring in many sectors resulted in a 50% downsizing of the public sector. In **Latvia,** a 1999 functional review of the Ministry of Agriculture identified 161 separate functions, of which nine were identified for privatization, 40 for rationalization, and twelve for transfer to other sectors. Implementation closely followed the proposed review.

The literature on functional reviews points to key success factors. First, such exercises involve setting general targets, but without specifying where they will be found. Second, aligning functional reviews with the budget process is essential to ensure that recommendations are provided at the appropriate point in the budget cycle. Third, one reason for successful reviews in OECD countries was that the legal mandates of the agencies and programs were flexible enough to allow relevant ministries to amend their own structure and services. Fourth, it is often difficult for such exercises to be successful in the absence of strong political leadership and/or ownership and buy-in on the part of line ministries and departments. Finally, a compelling need for such reviews, such as a looming fiscal crisis, can help gain the consent of the public.

Source: World Bank (2009)

The structure of public investment also needs to evolve to meet emerging needs. The challenge is to choose projects that address current bottlenecks. As China develops, the bottlenecks are also changing. From a spatial perspective, no economy will develop equally, and cities are more likely to be the poles of growth (World Bank, 2009d). For China, Luo (2005) finds that infrastructure investments in some inland regions such as Hubei and Sichuan could reduce the regional development gap without sacrificing much growth. Therefore, from the perspective of enhancing growth, more public investment could be spatially targeted to cities and selected regions.

In any case, the government needs to redefine its role and restructure its expenditures in line with its development goals. In China, this role has evolved significantly over the past 30 years, and should continue to do so. Once this has been decided, practical adjustments to current spending patterns need to be agreed and implemented, taking into account China's specific organizational arrangements. One way to begin this process is through the use of functional reviews (Box 4).

2. Further reform of taxes and other revenue sources

To achieve its 2030 vision, China will need to adjust its revenue policies to (i) generate adequate on-budget revenues to cover expenditures, (ii) cut efficiency-reducing distortions, and (iii) promote social and environmental objectives. The main challenges and opportunities are focused in three main areas.[18]

First, China has significant untapped potential to introduce or expand revenue sources which simultaneously promote all three of the noted objectives. These are concentrated in four areas, two at the national level, and two at the subnational level. The most significant *near-term* source of additional revenues is the collection of higher levels of SOE dividends and their full channeling to the budget. This could spur more efficient investment planning in SOEs while also generating significant resources.[19] For example, were SOEs to pay out half of their profits to the budget—a ratio prevailing in developed countries—budgetary revenues would grow by about 3% of GDP. In the *near- to medium-term*, higher taxes/prices on energy (carbon), water, natural resources and pollution would encourage their more efficient use while improving environmental outcomes and generating major revenues.[20] For example, Stern (2011) estimates that a tax on coal at fairly modest carbon prices (e.g. \$20/tonne of CO_2) could yield revenues equivalent to 2 or 3% of GDP. In addition, enhanced taxation of motor vehicle use and charges on parking (as a *near-term* option) and congestion (as a *longer-term* option) would lead to more efficient and livable cities and better environmental outcomes. Motor vehicle taxes piloted in Shanghai, and global experience with congestion charges, e.g. in Singapore and London, could offer useful guidance. Finally, as elaborated in greater detail in the subsequent discussion of land policy, expansion of property taxes to residences would encourage the more efficient use of land while also reducing urban sprawl. While promising, property taxes will require time before becoming a major source of overall revenues, with very few developing countries raising more than 1% of GDP from this source (Bahl, 2009).

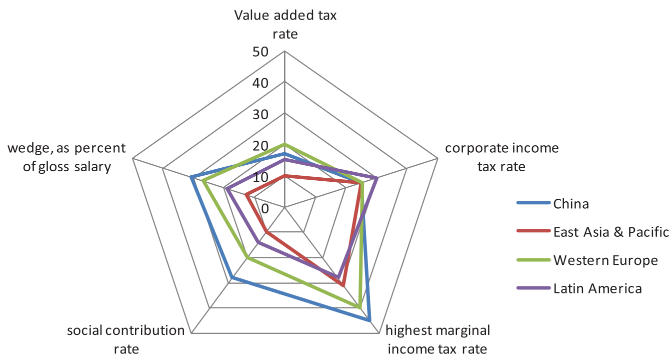
Second, reform of labor taxes can promote both greater efficiency and reduced imbalances. Figure 2 gives a comparative picture of the main tax rates on goods and services, corporate income and labor income. This shows that while China's taxes on goods and corporate income are not out of line with Western European and Latin American averages, its marginal rates of labor taxation are far above global norms. Its top marginal rate for personal income tax (45 percent), total pension contribution rate (28 percent of average salary of formal employment) and the overall labor tax wedge are high by any standard.[21] This works to reduce formal demand for labor and keep the wage share in GDP low, promoting inequality and discouraging consumption. Despite these high rates, major exemptions at lower income levels mean that China mobilizes surprisingly little from PIT. Fiscal Reform and Economic Governance (2011)

[18] Other important revenue side reforms would include further expansion and reform of the VAT and a review of road tolls. Both changes could help make growth more domestically and services driven. Changing the turnover tax on services to VAT would not only lower the tax burden, but also improve services' competitiveness, and promote outsourcing and specialization.
[19] World Bank (2010a) provides a detailed discussion on SOEs dividend policy and international practices.
[20] Several such taxes address negative externalities. Unlike many other taxes, such taxes present few if any trade-offs when viewed in a more holistic way than through GDP alone, as they make prices better reflect the true marginal cost of a particular activity, including the damage to environment.
[21] Data are from Fiscal Reform and Economic Governance (2011). This only takes into account personal income tax and contribution to pension funds. Including contributions to health insurance and housing fund, China's overall labor tax wedge is even higher.

indicates that China raises around one percent of GDP from PIT, against a HIC average of 5.85%.[22] The PIT is also based on different rates for different types of income, introducing further distortions and inequities. At incomes beyond the basic exemption, the PIT becomes highly progressive (discouraging the formation of human capital), while the various social contributions are high and regressive, adding further distortions and encouraging evasion at both ends of the income spectrum. As a combined effect of still low levels of coverage, a narrow base and high levels of in-kind compensation and informal employment, China also collects relatively little from social security contributions despite their high rates (Figure 3).

A phased approach is advisable to reform the labor taxation. In the *near-term*, the contribution rate for unemployment insurance could safely be reduced by around one percentage point. In the *medium-term*, PIT could be consolidated to cover incomes from all sources (including capital gains), its base expanded by scaling back currently significant exemptions, and simplified with a lower marginal tax rate. If the first two effects were to dominate, and to be supported by enhanced collection effort, such a reform could possibly raise PIT revenues by around 1% of GDP in the medium-term and 2% of GDP or more in the more distant future. In the *longer-term*, China's social protection contributions could be reformed through reductions in average rates combined with efforts to address the regressivity introduced through high minimum contributions, complemented by other reforms to mitigate unintended effects on the finances of the respective social funds. The latter could include separating out the "legacy costs" of the pension system and funding these from general revenues. These issues are elaborated in more detail in a companion report.

FIGURE 2 Cross-country comparison of tax

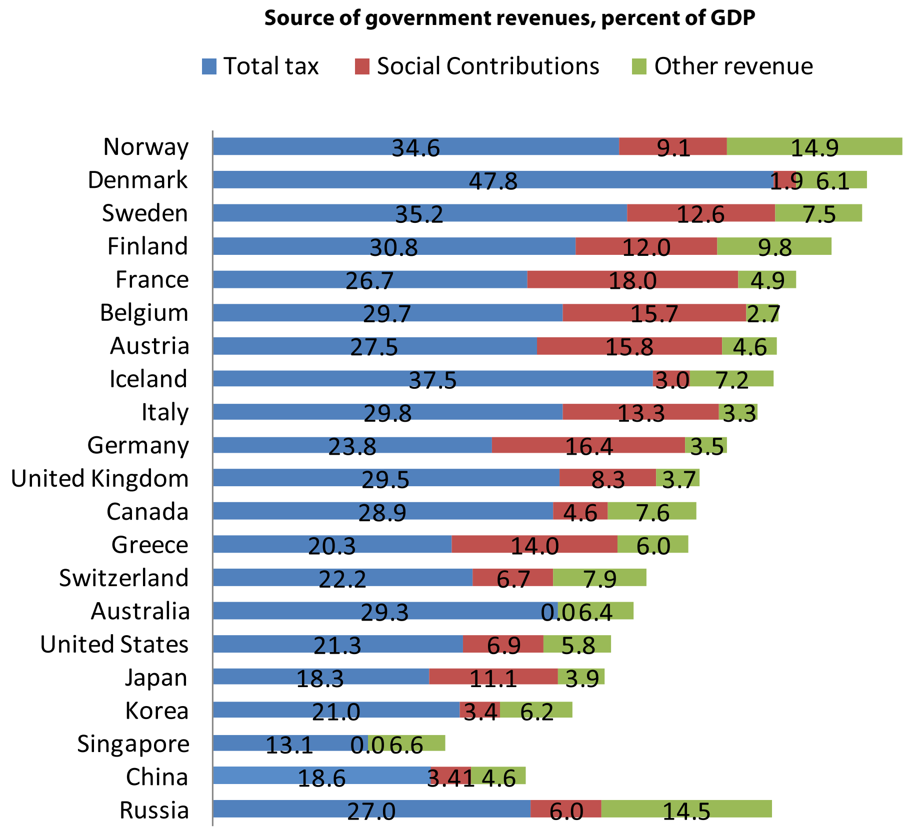


Source: Fiscal Reform and Economic Governance (2011)

Third, the taxation of land will need to shift away from transaction-related revenues towards a modern property tax. As elaborated in more detail later in this report, China's subnational governments derive substantial revenues from the sale of land use rights and taxes on real estate transactions. As prices and trading volumes in the property market can be highly volatile, such revenues may not be reliable for financing essential public services and put fiscal sustainability at risk. In addition, distorted incentives for officials in land development lead to inefficient use of land, corruption, and abuse of government power in land acquisition. As changes in land compensation practices will in any case lower the net resources which subnational governments can derive from such sources, they will need to find new revenues to fund their operations. As detailed below, expanding property tax to cover residences offers such potential in the *longer-term*.

[22] Furthermore, the "revenue productivity" of PIT—measured as the revenue collected as a share of GDP divided by the we ighted average PIT rate—is only 15% of global averages and 11% of HIC averages.

FIGURE 3 **Cross country comparison of government revenue**



Sources: Government Finance Statistics (2007, 2009), and staff estimation

Other important revenue side reforms would include further changes of the VAT, enterprise income tax and consumption tax. This could help rebalancing—making growth more domestically driven and services driven. Changing the excise tax on services to VAT will not only lower the tax burden, but also improve services' competitiveness, and promote specialization. China's current residence based enterprises taxes deprive poor provinces of significant revenues as company headquarters are usually located in richer provinces. They also have encouraged wasteful tax competition and beggar-thy-neighbor policies among sub-national governments. In the *medium term*, while the collection of VAT, enterprise income tax and consumption tax could remain residence based, the income could be attributed to various locations, based on the headcount of registered household, consumption or value added. (Xu, 2006)

3. Maintaining fiscal sustainability

Past fiscal reforms and prudent macro policies have left China with significant fiscal space. Over the past decade, fiscal balances have ranged from small surpluses to small deficits (1.6% of GDP in 2010). While off-budget borrowing by subnational authorities complicates the measurement of overall public debt, a conservative estimate of the debt of subnational governments based on a recent report by the National Audit Office would put overall public debt at around 44 percent of GDP by the end of 2010.[23]

[23] This includes 6.75 trillion RMB central government debt and 10.7 trillion RMB subnational government debt. Of total subnational government debt, 62.6% is explicit debt, 21.8% is contingent debt (guarantees), and the subnational governments have only limited rescue responsibility for the remaining 15.6%.

Several factors will work to preserve or even enhance this fiscal space. China's large growth potential creates the foundation for further growth of real revenues and favorable debt dynamics. China's state commands a large portion of assets including SOE shares and land which represent a source of potential revenues going forward. Large national savings coupled with investment grade sovereign risk ratings imply a relatively low cost of borrowing. Given these factors, China could in principle sustain somewhat higher annual fiscal deficits in the range of 3–4% of GDP.

At the same time, significant new pressures will challenge China in maintaining fiscal stability. Citizens' growing emphasis on social and environmental outcomes, rapid population aging, and further urbanization will put upward pressure on spending. As noted above, the combined effect of raising social expenditures towards levels observed at the lower end of the high income spectrum could alone add around 7–8% of GDP to total spending. In the absence of reductions in the share of other spending items in GDP, China's total fiscal expenditure would reach around 40% of GDP. As shown by the current sovereign debt crises in some high income countries, the revenue collection efforts required to finance such a level of spending could either be inconsistent with rapid growth or (if patently infeasible) with macroeconomic stability. The conversion of currently quasi-fiscal liabilities (e.g. of UDICs) into explicit public debt could add further fiscal pressure. At the same time, slowing economic growth will cut the potential growth rate of total fiscal revenues below past levels, while the government faces pressure to cut taxes to boost household disposable income and facilitate restructuring.

Meeting the triple challenge of maintaining fiscal stability, sustaining rapid growth and addressing social and environmental imbalances will require choices in the face of difficult trade-offs. Even among high income countries, different countries handle such pressures in different ways, in line with their specific circumstances and preferences. If China does not want to grow its size of government to average OECD levels, part of the adjustment will need to come from containment of some expenditures. In the *near-term*, this could include cuts to capital transfers and other enterprise subsidies, streamlining government institutions and employment, and regulating "on the job consumption". *Over time*, as China's front loaded public investment program achieves its initial aims, such investment could begin to be scaled back. Given China's fiscal space and the existence of major untapped revenue sources, a large part can come from the scaling up of several taxes (noted above). Such trade-offs will be eased by reforms to enhance the efficiency of government, including through the functional reviews described above.

As a specific tool for promoting fiscal sustainability, China could construct a macro-fiscal framework (usually comprising of medium-term budget plans and dynamic debt sustainability analysis), linked to the five-year development plan. Such tools, employed at both national and local levels, would help ensure the consistency of public spending with the country's development strategy and resource envelope. First, they would reveal the implications of current decisions on taxation and spending on future budgetary and financing needs. Second, they can bring out the fiscal risks emanating from various sources such as contingent liabilities being called, global shocks hitting output growth, etc. Third, they can help evaluate the government's capacity to meet current and future financial obligations. Were such analysis to show that debt limits are likely to be breached over the projection horizon, the government's plans will need to be revised accordingly.

Fiscal sustainability would also be promoted by bringing subnational government borrowing on budget. Currently, while such governments can formally borrow only with State Council approval, they circumvent this limit by borrowing through UDICs and other vehicles. Total sub-national government debt has reached 26 percent of GDP according to the National Audit Office. Such indirect borrowing played a key role in financing important infrastructure investments and thus supporting industrialization and urbanization. Debt financing will remain important for China's urbanization drive, which demands continuing large investments in urban transit, metro, power, water, sewage, etc. However, limited transparency and regulation has created potential risks to fiscal sustainability and the quality of bank assets. Formally, borrowing through UDICs should be for revenue generating purposes that can pay back the loan. In reality, a part of such borrowing appears to be for other purposes. Such quasi-fiscal financing also obscures the true size and composition of public spending and revenues. By preventing a unified planning, execution and monitoring of public spending, it can also lead to inefficient and sub-optimal allocation of public funds.

Allowing subnational governments to access the financial market could have important benefits. Matching the economic life of assets that the debt is financing with the maturity of debt is sound public policy because these infrastructure services can and should be paid for by the beneficiaries of the financed services. Market access and the operation of an active secondary market expose subnational governments to market disciplines and reporting requirements, helping strengthen fiscal transparency, budget and financial management, and governance. A competitive subnational credit market with numerous buyers, sellers and financial options, such as bonds competing with loans, can help diversify financial markets and lower borrowing cost.

Moving forward, the central government needs to establish an institutional and regulatory framework to reap the benefits while mitigating the risks of subnational borrowing. As demonstrated by over 200 years of subnational infrastructure financing in the United States, subnational debt financing is viable under sound regulatory frameworks. The government's recent inventory of all subnational government borrowings is an important first step towards transparency in quantifying the liabilities of subnational governments and their entities, and lays a good foundation for further steps. Box 5, based on Liu (2010) and Liu and Pradelli (2011), provides indicative elements of a regulatory framework for sub-national debt management.

Direct borrowing by subnational governments could be phased in, beginning with authorities with the greatest revenue capacity and most reformed fiscal system. Financially weaker localities could initially rely more heavily on transfers, with the central government establishing clear rules about when a subnational government can graduate from one status to another. Preconditions for UDIC borrowing would include corporate governance reform and clarity in its financial relationship with the subnational government. Credit ratings and disclosure of audited financial accounts (UDICs) and fiscal accounts (subnational governments) are prerequisites for borrowing from the financial market. Those sub-national governments and UDICs that are allowed to borrow should be subject to hard budget constraints, without recourse to central government support. It is important for the central government to send a credible "no-bail out" message to the market, documented in legislation, and demonstrated in action.

BOX 5 Indicative regulatory framework for sub-national government debt

Core components of a sub-national government debt regulatory framework are *ex ante* regulation and an *ex post* insolvency system. In China, a complete regulatory framework would also include strict regulation on UDIC borrowing.

Ex ante regulation. The framework would spell out ex ante rules governing the purposes of SNG borrowing (e.g., long-term borrowing for public capital investments only), types of debt allowed (e.g., prohibiting exotic financial products), and procedures for issuing debt. Fiscal targets can be established quickly focusing on the debt service ratio, balanced operating budget, and guarantee limits, while developing thresholds for fiscal sustainability assessment would take more time and effort. Fiscal transparency would be a precondition for SNGs/UDICs to access capital markets. Credit assessment by reputable rating agencies can be required of all SNGs/UDICs wishing to access the capital markets. Only those SNGs that have adopted fiscal transparency and budgetary reforms could access the markets.

Ex post insolvency system. International experiences have demonstrated that unconditional bailouts of SNGs and their entities lead to moral hazard, encouraging irresponsible fiscal behavior and reckless lending by creditors. In the *near-term*, China can develop two sets of monitoring indicators for SNGs: one measuring fiscal deterioration and another one for fiscal insolvency. The key is to monitor, and intervene early, to prevent SNGs from deteriorating into insolvency. Over the *longer-term*, a more systematic insolvency system can be developed to include debt restructuring rules and a priority structure for settling claims.

Regulating UDICs. As part of ex ante regulations, UDIC long-term borrowing must be for public capital investments, ratios of operating revenues to debt service would be established and pledge of assets as collateral be regulated. Subnational government guarantees of UDIC borrowing can play a useful role but would follow prescribed rules such as total guarantees provided would be below a percentage of SNG revenues and no single UDIC borrower could have guarantees exceeding a certain percentage of total guarantees by a subnational government. The US regulation for subnational SPVs can provide a useful reference.

To ringfence and reduce fiscal risks, China could develop regulatory frameworks for UDICs to issue revenue bonds. In contrast to the general obligation bonds, revenue bonds are secured by the revenue stream generated by the project that the debt is to finance. Revenue bonds reinforce self-sustaining finance, and allow the market to play a central role in enforcing debt limitation, pricing risks, and matching the maturities of liabilities with the economic life of assets. In the US, revenue bonds account for about two thirds of US$3 trillion subnational debt outstanding.

Developing revenue bonds can be supported by complementary reforms, including: corporate governance reform, regulatory frameworks for setting tariffs, and standardized reporting, audit and market disclosure requirements. Financial strength is assessed through a credit rating system that assesses a borrower‘s ability to pay debt. Hard budget constraints on SPV are a must.

4. Further reforming the inter-governmental relationship

Achieving a harmonious high income society by 2030 will require further complex reforms of China's system of local finance and inter-governmental fiscal relations. The key challenges for China's fiscal system in supporting this agenda remains high fiscal inequality and a decentralization of many functions which are usually financed or provided by higher levels of government in most high income countries. Reforms in four areas stand out: (i) completing the move from five to three levels of government; (ii) selectively raising some functions to higher levels of government; (iii) introducing some more formal central government involvement in sub-provincial distribution; and (iv) introducing new sources of subnational own revenues.

First, the ongoing move from five to three (budgetary) levels of government could be completed. This is a key step towards streamlining the size of government, improving the efficiency of government services, and empowering county governments. Such reforms in the fiscal management system are already being introduced in 27 provinces, covering over 900 counties.[24] Most piloted county governments witnessed improved revenue capacity with increased transfer directly from the province (circumventing the municipal level—a tier between province and county) and enhanced monitoring of county finances by provincial governments. Moving forward, a natural step would be to gradually expand this reform to the whole nation. While international experience provides limited clues, China's own pilot programs suggest it has strengthened the fiscal capacity of county governments, reduced the overall cost of government, and improved the delivery of public goods and services. Implementation of such reforms should pay due attention to avoiding gaps in, or shocks to, service delivery in the transition period.

Second, to enhance efficiency and equity and to strengthen the national market integration, some expenditure responsibilities or their financing could be raised to higher levels of government. The economic literature prescribes that a function should be assigned to the level of government that best matches benefits and costs of that function, whereas the "subsidiarity principle" would lead to assignment of a function to the lowest possible level (Dollar and Hofman, 2006). These considerations still leave much scope for interpretation. In practice there is considerable variety in the assignment of functions among countries. As Table 4 shows, China is much more decentralized than OECD and middle income countries on the spending side. In several cases, China's assignment of functions is out of line with theory and global good practice. In most-countries, income-maintenance responsibility (pensions, disability, and unemployment insurance) is the task of the central government. This is for good reason, as it can help pool the risks across regions and encourage labor mobility and participation. In China, this also has an equalization effect, as some coastal provinces have relatively high employment-to-retiree ratios thanks to many migrant workers. Specific areas where there is potential to raise some expenditures or their financing to higher levels of government are discussed in a companion report.

TABLE 4 Share of sub-provincial governments in total government

	Developing Countries	OECD Countries	Transition Countries	China
Sub-provincial share of Government Tax Revenues	9.27	19.13	16.59	34.2
Sub-provinical share of Government Expenditure	13.78	32.41	26.12	59.3

Source: Dollar and Hofman (2006), staff calculations

Third, China could consider introducing more formal direct central government involvement in sub-provincial fiscal relations. As the tax sharing arrangements introduced in 1994 were not extended to the sub-provincial level, the most serious fiscal disparities remain at that level, which accounts for over 50% of total public spending. In 2005, provincial governments on average took about 25 percent of total sub-national revenue, municipal governments a further one-third, and county governments, which provide most services, took the remaining 43 percent. Sub-provincial fiscal arrangements remain at the discretion of provincial governments, leading to high variation across provinces. For example, the share of provincial governments in sub-national revenues ranged from 60 percent in Tibet to only 14 percent in Shandong, while the county governments' share ranged from 24 percent in Tibet to over 60 percent in Zhejiang.[25] In general, the higher level government grabbed a higher fraction of fiscal revenue than

[24] Source: The Final Account of Chinese Central Government of 2010, Ministry of Finance.
[25] The big three central-government directly administered metropolises (Beijing, Shanghai and Tianjin) have very small county-level governments.

its share of expenditure responsibilities. As a result, the most serious vertical and horizontal imbalances are at the lower levels of government (counties and below).

One option for addressing sub-provincial disparities would be setting some limits on the expenditure autonomy of subnational governments. Any such solutions would be guided by (and possibly limited by) a clear understanding of the specific role of subnational government in China. As in other unitary countries, while local authorities are in principle an agent of the central government, they still enjoy a high degree of autonomy. In many cases, the central government determines by law what type of activities subnational governments can be engaged in through a positive list of functions (an "ultra vires" definition of subnational governments). But even if subnational government is granted a wide range of autonomy ("general competence"), the central government could consider specifying at least those functions that it must perform.

A second option would be for the central government to get involved in the sub-provincial distribution of resources. For example, the center could, as a minimum, establish expenditure needs for each level of government, and set limits on the disparities among sub-provincial governments. Once the assignment of expenditure responsibility to subnational governments is decided, revenues would be assigned to ensure adequate resources to perform these tasks. In this process, the center could mandate some degree of uniformity in sub-provincial revenue assignment and transfer. One very ambitious option would be requiring the provinces to transfer revenues to the county level in the same way as transfers are allocated to the provinces. Alternatively, the center could mandate the provincial governments to achieve certain prescribed targets, such as a minimum level of education expenditure per student, and revenue capacity equalization at some level.

Fourth, beyond the property taxes noted above, there is further scope to introduce new sources of own revenues of subnational governments. The high disparity in development warrants some flexibility in revenue assignment. China could consider first granting new sources of own revenues to subnational governments in relatively developed cities. This would free up fiscal resources for more transfers to poorer regions, and help bring a larger share of subnational financing on-budget. This may also help reorient the enthusiasm of subnational governments from growth and investments to a more balanced growth strategy that reduces rural-urban disparities (discussed below in section on land policy). Finally, it could improve accountability, as citizens will hold officials more accountable if local public services are financed to a significant extent from locally imposed taxes. A good local tax should meet several criteria. The subnational government should be able to set the rates itself, at least within limits. It should be visible to local taxpayers, large enough to finance a chunk of local services, and not easily exported outside the jurisdiction. In addition to the property taxes, motor vehicle and congestion charges noted above, own revenues could also include a local PIT, possibly as an add-on to the central government PIT tax rate. However, as the top national tax rate of 45 percent leaves little space for such an addition, reform of PIT to cut the top marginal rate may be crucial for meaningful progress on granting subnational governments more flexibility to raise own revenues.

5. Institutional reform to enhance accountability and transparency at all levels

Improved information and greater fiscal transparency at all levels of government would bring many benefits. These include greater efficiency, reduced corruption, and improved creditworthiness. Past reforms of government accounting classifications, and the construction of capital operating budgets and social fund budgets, have laid a good foundation for improving government self-regulation. A natural *near-term* step would be to further the reforms to make information accessible to taxpayers, research institutes and universities. More information in the public domain would allow better policy analysis and evaluation, expand citizens' scope for active participation in policy debate. This would ultimately lead to higher acceptance of policy choices and enhanced government credibility. Possible *medium- and long-term* measures include better aligning budget formulation and execution, moving the budget calendar to better reflect the schedule of the National People's Congress, changing from cash to accrual accounting, producing an inventory of government financial and physical assets, and eventually constructing the government's balance sheet. The upcoming revision of the budget law is an opportunity to anchor more transparency in fiscal and intergovernmental fiscal matters in law.

Despite past improvements, China still faces considerable challenges in enforcing *accountability.* This limits what the inter-governmental fiscal system can achieve in terms of efficiency and redistribution. Given the high degree of decentralization in China, a key issue is accountability of local authorities to the central government. Specifically, with limited accountability for results, more equalization of spending to poorer provinces could well lead to waste of resources rather than better service delivery for the poorer part of the population. To enhance accountability of subnational governments, the central government could consider the following four measures:

1. **Periodic evaluation of the fiscal implications of expenditure assignments.** Disparities among regions, the quality of basic infrastructure, priority areas for investment, and the technical capacities of subnational governments can all change over time. The central government must have flexibility to adjust to such changes. Such evaluation will need to bring out the fiscal implications (and necessary remedial policies) for the next five to ten years if any restructuring takes place. This is a bigger issue than just expenditure assignment. The financing of this shift in responsibility would likely include a reassignment of some revenue sources and reallocation of transfers as well.
2. **Development of a medium term fiscal framework and monitoring the fiscal development of subnational governments.** Local officials in China have inherent biases favoring the allocation of resources to physical investments and "leaping forward". These can lead to excessive (hidden) expansion of government debt, and fiscal stress in the medium and long run. One way to mitigate such risks is to require subnational government to develop a medium-term fiscal plan and undertake the assessment of debt dynamics. Through this process, the fiscal implications of any reform can be calibrated, and public expenditure and revenue decisions integrally articulated.
3. **Comprehensive evaluation of the performance of local officials.** Until recently, evaluation criteria for local officials were heavily focused on GDP growth. This is not hard to measure, and the accountability system has worked reasonably well. But the shift in focus to a "harmonious society" requires a greater focus on outcomes such as the health status of the population, educational attainment, energy efficiency, and environmental quality. As these mandates are spread among line ministries, it will inevitably be harder for the central government to know if the local government is doing a good job meeting these multiple objectives and to use that information in staffing and financing decisions.
4. **Cross regional and sectoral coordination.** China has quite a few transfers: some are allocated among regions, and others are earmarked for specific issues: for example, transfers for rural education. Each transfer program is administered separately and often allocated in an *ad hoc* manner. It is important to ensure that the different transfer programs combine to provide solid foundations for regional development, and to ensure equity across regions and consistency with the national development strategy.

One bold option for enhancing subnational government accountability in public services would be to establish a budget committee under the direct oversight of the State Council, and to centralize the performance evaluation and monitoring of local agencies (including the noted four functions) in a single ministry. Such a practice is adopted in many countries including Japan and Finland, either as a separate ministry or as part of an existing ministry, e.g. the Ministry of Finance.

Chapter 4 Enterprise Sector Reforms

A. The Enterprise Sector and China's Vision for 2030

A vibrant and increasingly efficient enterprise sector is key for sustaining relatively rapid growth and enhancing the innovativeness and global competitiveness of China's firms over the next two decades. It would support growth by promoting further productivity gains and by keeping returns to capital at levels which sustain high investment demand. Combined with a more favorable environment for SMEs, service sector firms, and labor intensive firms, it would also promote China's objectives of moving to a more innovative and harmonious society.

Successful reform and the resulting structural change would leave China with a very different enterprise sector by 2030. In nearly all industries, a range of firms with diverse size and ownership would compete vigorously on a level playing field, facing similar market-driven factor and input prices. The share of SOEs in industrial output would decline from the current 27% in 2010 to around 10% in 2030. Many sectors would have been greatly consolidated, primarily by market forces. Entry barriers could remain in a few "natural monopoly" sectors where dominant providers (whether state-owned or private) are subject to effective regulation. Large firms, including a diminished number of SOEs, would feature modern corporate governance with professional boards deciding key strategic matters. Having been made more competitive by vigorous competition from home and abroad, Chinese firms would be increasingly successful in global markets. Within government, the functions of policymaking, regulation and supervision would be better separated, each led by a single agency with strong capacity, clear mandates and accountability. Finally, "industrial policy" may still be implemented, but in a more focused, consistent, predictable and market-friendly way than today.

Going forward, China will need to determine the relative role of the state vs. the market and the private sector in economic activity. While a large state role may have had beneficial effects during the recent crisis, China's own experience over a longer period supports its further scaling back. As elaborated below, China's non-state enterprise sector is much more productive, profitable and innovative than its SOE sector. Much of China's impressive productivity growth over the past decade was driven by manufacturing, which had just been opened to greater competition. To sustain rapid GDP growth, China will need to extract more productivity from its currently protected services and utilities sectors. One way to get this is through the same model that worked so well for manufacturing: expose firms to competition through deregulation, international trade, and private participation. In addition, the relationships between government and enterprises need to be reformed to allow firms with different ownership and sizes to have equitable access to resources and business opportunities.

B. China's Enterprise Sector—Key Developments to 2010

Significant enterprise sector reforms have underpinned China's successful past growth performance. In particular, bold reforms under the 9th Five Year Plan (5YP) 1995–2000 led to a greatly expanded role of the private and other non-state sector. Indeed, the state sector's share in the total number of industrial enterprises (with annual sales over 5mn RMB) fell from 39.2 percent in 1998 to 4.5 percent in 2010. During this same period, SOEs' share in total industrial assets fell from 68.8 percent to 42.4 percent, while their share in employment was slashed from 60.5 percent to 19.4 percent (Figure 4). Their share in China's exports fell from 57 percent in 1997 to 15 percent in 2010. As a result, the non-state sector has become not only the main generator of output (an estimated 70 percent of GDP) and employment, and strongest growth engine, but also the most active sector for innovation. According to Jia (2009), 65 percent of China's patents and 75 percent of technological innovations came from the non-state sector.[26]

The 9th 5YP's guiding principle of "grasping the big, letting go of the small" left China with a distinctive industrial structure. Most small and medium-sized firms became privately owned. Facing much domestic and external competition in an increasingly integrated domestic market, they became very dynamic and productive and now dominate many sectors (Economist, 2011). In parallel, the "commanding heights" of the economy (most notably the 120 or so large central enterprises in sectors like electricity, petroleum, aviation, banking and telecoms) were kept largely state-owned. Even here, much progress was made. Many SOEs were corporatized, radically restructured (including labor shedding), and expected to operate at a profit. In some sectors, intra-SOE competition was promoted and the scope for private participation was expanded. Later, the 2003 establishment of the State-owned Assets Supervision and Administration Commission (SASAC) to exercise authority over large centrally run firms laid a foundation for future improvements in governance and investment planning.

As a result, the profitability of China's SOEs increased. Their reported average return on equity (ROE) jumped from only 2.2 percent in 1996 to 15.7 percent in 2007, before sliding back somewhat to 10.9 percent in 2009 (Figure 5).

However, the average profitability of SOEs remains well below that of non-state (including private) firms. During 1998–2007, the ROE of SOEs jumped by 13.8 percentage points (pp), while that of non-state firms grew by a smaller 12.8 pp (Figure 5). Still, in 2009, the average ROE of non-state firms remained 9.9 pp above that of SOEs. In addition, a disproportionate share of SOE profits comes from a few monopolies that earn artificially high rates of return because of limits on competition, while SOEs as a class have enjoyed access to cheaper capital, land and natural resources.[27] As a result, the profitability of SOEs in less state dominated sectors is generally poorer, suggesting an even greater underlying advantage for non-state firms. The superior performance of private and other non-state firms is also confirmed by a wide range of other research although the financial performance of some SOEs has been weak in part because they have been responsible for delivering public services or have been constrained by regulated prices.

FIGURE 4 SOEs have declined in relative importance

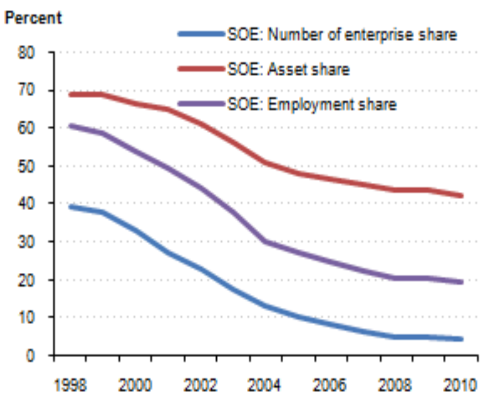
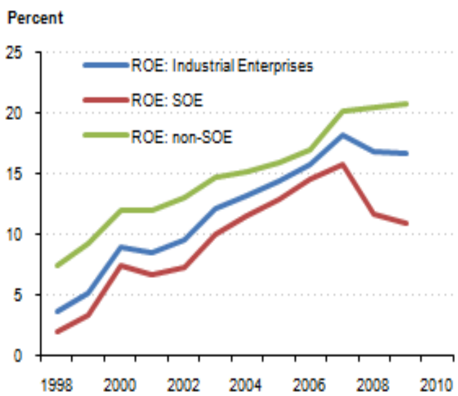


FIGURE 5 The rate of return for non-state firms exceeds that of SOEs



[26] Jia Qinglin, "Remarks in the 3rd conference of commending the outstanding builders of Chinese characteristic socialism in the private sector", *People's Daily*, November 7, 2009.
[27] For example, Ferri and Liu (2009) find that the cost of debt is significantly lower for SOEs,even after controlling for individual firm features. They estimate that should SOEs pay the same loan rates as otherwise equivalent private firms, the additional interest payment would have wiped out their profit in 2004 and 2005, the two last years in their sample.

A significant expansion of competition contributed to productivity gains (World Bank, 2009c). Privatization and market reform generated vibrant competition in most manufacturing sectors. In some "strategic" or "pillar" sectors (airlines, telecoms, etc), some inter-SOE competition was encouraged by the breaking up and corporatization of incumbent providers.[28] China's opening to the outside world, especially WTO accession in 2001, enhanced competition from abroad. Finally, the more recent phasing out of incentives which had favored foreign investors enhanced competition by leveling the playing field with domestically-owned firms. For this reason, and also due to China's vast size, the overall industrial sector is not very concentrated (Box 6), suggesting strong potential for competition between individual firms.

BOX 6 China's industrial concentration remains low in most sectors

Sutherland and Ning (2008) compare the evolution of industrial concentration in China with that of earlier periods in Japan and Korea. While such international comparisons are hampered by lack of strict comparability of data, they remain instructive. Citing Amsden and Singh (1994), in Japan, the average (unweighted) *three*-firm (C3) concentration ratio was 57.6 in 1937, 53.5 in 1950 and 44.1 in 1962. In South Korea, the all-industry average C3 ratio was 62.9 in the 1980s. For China, the authors calculate a *four*-firm (C4) average of only 23. Thus, Chinese industry appears significantly less concentrated than Japan and Korea in earlier periods.

Looking at individual sectors, Sutherland and Ning find only three industries in which the C4 ratio exceeded 40 in 2006: extraction of petroleum and natural gas; processing of petroleum, coking, processing of nuclear fuel; and production and distribution of electric power and heat. These industries accounted for only 14.4% of total sales across the 37 surveyed industries. Only 5 of the 37 industries had C8 concentration ratios above 40%. By these definitions, only a small share of Chinese industry, found in traditional pillar industries, could be considered uncompetitive by these rather crude but often used metrics.

OECD (2010) also finds that standard measures of concentration are relatively low and declining in China. Using the Herfindahl-Hirschman index, and grouping results by US Department of Justice merger thresholds, they find that the number of industrial sectors at the four-digit level deemed to be highly or moderately concentrated has decreased from 27% in 1998 to only 14% in 2007. This is low by international standards, including when comparing with the United States.

However, competition remains curtailed in one key dimension—between state-owned and non-state parts of certain sectors—especially in "strategic" industries and utilities. Large SOEs dominate certain activities not because they are competitive enough to keep the dominance, but because the market competition is restricted and they are granted oligopolistic status by the authorities (Lin, 2010). The weak and unfair competition resulting from such "administrative monopoly" (Box 7) has been deemed "*the* current problem facing private enterprise in China" (Naughton, 2011) and "the major source of monopolies in China's economy" (Owen and Zheng, 2007). The strong direct ties between the government and incumbent SOEs, especially large SOEs, limit the entry and access to resources of private firms, hampering the efficient use and allocation of resources and stifling entrepreneurship and innovation.

[28] However, in some sectors such as telecoms, the splitting up was along geographic lines, still leaving a single dominant provider in any given area.

BOX 7 Administrative monopoly

"Administrative monopoly" refers to market power artificially created by government policies which restrict competition or compel anti-competitive conduct. It differs from a natural monopoly, where market power derives from structural factors such as economies of scale or scope. In China, the most important are explicit or implicit restrictions on (private and/or foreign) entry into (or expansion of capacity within) a still rather wide range of activities, particularly in services. They can also include government mandated use of specific products or services, or discriminatory treatment of non-local firms or products by local governments ("regional blockades"). They can be exacerbated by government agencies requiring approvals for a range of activities, at times in the absence of statutory authority.

The most problematic form of government intervention in competition and administrative monopoly in China is official lists which grant SOEs an exclusive or privileged role in certain sectors. Two lists stand out. First, in 2006, China identified 7 "strategic" sectors in which the state would keep "absolute control"—defense, electric generation and distribution, petroleum and petrochemicals, telecoms, coal, civil aviation and waterway transport.[29] In such sectors, while a handful of state firms might compete with one another, they are protected from new entry (Naughton, 2007). Second, in designated "basic or pillar" industries—including machinery, automobiles, information technology, construction, steel, base metals, and chemicals—the state would retain "somewhat strong influence" (Owen and Zheng, 2007). In such sectors, private participants could face a range of entry barriers or other constraints.[30] Also, the clear signaling of the expected leading role of state enterprises could lead private firms to conclude that they would not be allowed to grow "too big", acting as a powerful disincentive to expansion if not entry. As described in Box 8, such barriers to entry and exit can reduce potential growth of GDP and TFP.

These lists are long by high income country (HIC) standards and include many activities where vigorous competition is feasible. Most countries rightly limit entry into *bona fide* "natural monopoly" sectors. Until strong regulatory capacity has been established, there may also be a case for keeping such firms state owned. However, even in such sectors, technological advances have made large sub-sections potentially competitive, e.g. much of the telecoms sector, and a good part of electricity generation and distribution. Furthermore, in most HICs, vibrant competition and extensive private participation now exists even in sectors which China has deemed "strategic", e.g. coal and air transportation. Most if not all of China's current "basic and pillar" industries are inherently competitive and are not (or are no longer) subject to high levels of government ownership in HICs. Thus, such administrative barriers may be precluding significant efficiency enhancing competition in China.

[29] For example, in 2006, all of petroleum, natural gas and ethylene, all basic telecoms services, about 55% of electricity generation, and 82% of airline and air cargo traffic were by SOEs (Owen and Zheng, 2007).

[30] Even if entry is allowed, and even beyond areas considered "strategic", private firms can face a range of other disadvantages. Ferri and Liu (2009) document significant advantages in borrowing terms for SOEs. In an overview of prospects for private airlines in China, Pan documents other regulatory and financial advantages of SOEs, including in securing bailouts via capital injections and in access to bank financing. Tian (2007) documents entry barriers in the automobile industry.

BOX 8 **Entry, exit and "creative destruction"**

Rates of entry and exit have been significant, but possibly different across market segments. Strong entry and exit is critical for competition. Brandt, van Biesbroeck and Zhang (2009) find that China has derived a large share of its TFP growth from massive entry of new productive firms and exit of inefficient incumbents. Over their sample period, net entry contributed over 2/3 of total productivity growth, even more than its contribution in US manufacturing. However, this average could hide variation across firms of different size, sectors and ownership. Emerging evidence suggests that such creative destruction is indeed strong among smaller firms.

Low turnover among larger companies could work to limit gains in productivity going forward. Several new studies suggest that dynamic economies with sustained high TFP growth tend to have relatively rapid turnover among large industrial enterprises. For example, Fogel, Morck and Yeung (2007) study the impact of the stability of the top 10 firms on GDP and TFP growth in 44 countries. They find faster growth in countries where big business is less stable, i.e. with "upstart firms undermining stagnant behemoths." This relationship is particularly strong among higher income countries. While rapid growth in low-income countries can arise from improved factor reallocation, higher-income countries also need "creative destruction" to push out the frontier and develop a more dynamic industrial sector.

Policies which create an unlevel playing field or increase the uncertainty faced by businesses further limit efficiency gains. As a result, state and non-state firms coexist while behaving differently in the face of very different incentives, leading to distortions in resource allocation. While non-state firms have driven China's rapid economic growth, less efficient SOEs remain in business. In a detailed examination of the relative performance of these two groups of firms (using China's industrial census data), Li and Xia (2008) seek to explain how firms with different ownerships deploy resources and formulate strategies to achieve their goals. While non-state firms outperform SOEs in labor productivity, cost control and profitability, SOEs have had better and more stable access to government allocated resources like bank credit (see discussion of financial sector below). This greater predictability and cost advantage has allowed SOEs to undertake longer-term investment and maintain greater slack in the form of inventories. In contrast, less effective property rights protection and less access to government allocated resources has forced non-state firms to take a shorter-term perspective, and focus more on low cost production and market allocated resources.

C. Industrial Interventions

Finally, since the late 1980s, the Chinese authorities have implemented extensive interventions, including industrial administrations and industrial policies. Industrial administrations include administrative approval (*shen pi*) or reporting (*bei an*), administrative inspection, mandatory closure of business, and other restrictions on firms which are deemed to have inappropriate industrial activities. Industrial policies are more formal than industrial administrations but they are often connected. In broad terms, industrial interventions are designed to affect the allocation of resources among economic activities (across or within sectors) to achieve a different outcome from what otherwise would have occurred. Such policies are most critical in sectors with both state and private ownership, but with a dominant role envisaged for SOEs. They have involved a range of actors across all levels of government applying a variety of instruments to achieve multiple objectives across a large part of the enterprise sector. As a result, China has become one of the world's most active users of industrial policies and administrations.

Such interventions are *implemented* by three broad classes of *actors* (see Annex 2 for details). The *first* are high level national bodies, such as the State Council, the National People's Congress (NPC) and the Communist Party of China (CPC). The *second* are central government departments, including the National Development and Reform Commission (NDRC), the Ministry of Industry and Information Technology (MIIT), and others. The *third* are sub-national governments and their departments. While such governments are expected to help execute national policy, their extensive responsibilities also give them the means to influence industrial development, such as industrial planning, fiscal policy, access to land, and ownership of local SOEs. Two prominent examples of provincial industrial policy include efforts of Shandong and Shanxi to restructure their iron and steel industries and coal industries, respectively (Box 9).

The noted actors use at least five types of *instruments* to pursue industrial interventions. These are: (i) policy statements;[31] (ii) legislation; (iii) resolutions (of government departments or ministries which require the subordinated system to follow); (iv) written and oral instructions; and (v) "special inspection and re-organization".[32]

As elaborated in Annex 2, China's industrial policies have had seven defining *characteristics*. *First*, they have been scale-oriented, i.e. focused on the development of larger enterprises. As such, they have disfavored SMEs. *Second*, they have sought to control the expansion of sectors deemed to have excess capacity. *Third*, they have aimed to concentrate sectors deemed to be too fragmented. *Fourth*, policies to encourage technological advancement, e.g. requirements to use specific (local) technologies, have had industrial policy dimensions. *Fifth*, they have relied heavily on direct administrative intervention to introduce (withdraw) resources from preferential (prohibited) sectors. *Sixth*, they have often featured multi-division joint action. *Finally*, and importantly, such policies have been pursued at each level of government, often at cross purposes. For example, while the central government may have aimed to consolidate a sector nationally, several provinces may have sought to make it a "pillar" for its own economy. With over 30 provinces and many more sub-provincial authorities involved, the degree to which a particular sector is ultimately favored or discouraged becomes hard to discern. Enterprises facing such competing pressures face a treacherous business environment.

BOX 9 Provincial-level industrial policies in Shandong and Shanxi

In 2007, the Shandong government issued "Opinions of Shandong Provincial Government on Further Speeding the Adjustment of Iron & Steel Industry Structure". In 2007, the province combined the Jinan Iron & Steel company with the Laiwu Iron & Steel Company to set up Shandong Iron & Steel Group Corporation (SIS). Over time, it gradually brought small and medium iron & steel firms into SIS to enhance industry concentration. In 2009, the Shandong government issued "Adjustment and Revitalization Plan of the Shandong Iron & Steel Industry (2009–2011)", which included the stated aim of raising SIS to become a very large scale iron & steel group, to raise 3 to 5 other specialized medium-sized iron & steel enterprises, and to accelerate the shift of the industry to coastal areas. In 2010, the Shandong Provincial Committee of the CPC passed a proposal for formulating the province's 12th 5 Year Plan, which again advocated enhancing iron & steel industry concentration, including by merging Rizhao Iron & Steel Group into SIS, so as to achieve a production capacity which would represent more than 75% of the provincial total. Another example is Shanxi Provincial government's promotion of a radical reorganization of its local coal industry. In 2008, after the provincial government issued "the enforcement opinions on speeding up the merger and restructuring of coal enterprises", most small coal enterprises (usually private firms) were administratively merged with large coal enterprises (usually SOEs).

[31] Examples include sections of work reports to CPC congresses, policy guidance for 5YPs, and comprehensive or single sector policy documents.

[32] The latter policy is implemented by bodies such as the General Administration of Quality Supervision, Inspection and Quarantine, the State Food and Drug Administration, and the State Administration of Work Safety. Such inspections and reorganizations can bring significant restructuring within sectors. For example, in April 2011, nearly one-half of China's dairies were shut down after having their licenses revoked.

As in any country, views on the overall effectiveness of industrial policies vary widely. As might be expected, the more positive evaluations tend to be by government institutions,[33] while more critical perspectives tend to be by academic specialists.[34] There is more agreement on positive achievements in some more specific instances, for example regarding policies directed towards the textiles sector in the late 1990s.[35] Many also argue that excess capacity would have been even worse in the absence of efforts to restrain capacity expansion, for example in the steel industry over the past decade.

However, China's industrial policy has been unsuccessful in at least two dimensions. First, actual developments have often differed from those programmed by the authorities. In some cases, targeted sectors failed to emerge. For example, in 1982, the State Council set out to promote the Very Large Scale Integration (VLSI) industry. While these efforts were supported with significant funds from the 7th to 10th 5YP periods, the result was disappointing.[36] In other cases, the sectors did emerge, but on a slower timetable. For example, the auto industry was identified as a "pillar industry" as early as the 7th 5YP period 1986–1990. Despite being nurtured, the industry made little progress during the 1990s, probably because China had not yet reached a level of income which would support rapid growth of auto ownership. The sector only took off in the last decade after incomes had risen and China had joined the WTO.[37] Finally, other industries flourished without being picked as winners, such as the construction machinery cluster in Changsha, Hunan Province.

Second, and most strikingly, despite concerted efforts to increase concentration, and despite much M&A activity, industries subjected to industrial policy have often fragmented further. Under the 10th 5YP, the authorities tried to increase the market share of the top 10 iron and steel producers from 50% in 2000 to 80% in 2005 (OECD, 2006). In fact, this share dropped to 34.6% in 2004 before rising somewhat to 43% in 2009. Similarly, in 1994, the central government published "the development policy for China's auto industry", which aimed to nurture 2–3 large auto companies within the 20th century. In fact, the concentration ratio of the auto industry remained very low and tended to decline over the 1990s (J. Hu, 2008). While the central authorities can strongly influence the expansion of major producers, other firms are also expanding.

One key reason for the ineffectiveness of China's industrial policies is the country's five-layer government. In addition, the incentives faced by local officials exacerbate the fragmentation of strategically important sectors. Large industrial firms are important local employers and taxpayers. As local authorities are entitled to 25% of the VAT levied on products produced in their jurisdiction, they may protect existing firms or compete vigorously to attract new ones. Local official become especially anxious about cross-provincial mergers which could cut local jobs or transfer the tax base to another jurisdiction. In some cases, these may be the same firms that central authorities are seeking to close, e.g. due to inefficient technology or high levels of pollution. Informational asymmetries and pressure from local interests can exacerbate such tensions.

Finally, industrial policies affect enterprise performance via three other channels:

---

[33] For example, State Information Center (2007), NDRC (Ou and Liu, 2007), and Yuan (2010).

[34] For example, Shi and Wang (2011), Jiang (2010), and Yang (2004).

[35] At that time, the central government issued a policy aimed at eliminating outdated plants and reducing some capacity in that industry. Measures included mandatory closure of outdated plants, subsidies for restructuring and equipment replacement, and preferential placement for fired workers. After 3 years of implementing this policy, China's textile industry was substantially upgraded.

[36] Similar cases can be found at the provincial and local level. For example, some local governments regarded the software industry as a local pillar industry and implemented preferential policies more than 10 years ago. However, the software industry remains weak in many of these localities.

[37] Some automotive firms favored by industrial policy, such as Tianjin Xiali, Guangzhou Peugeot, and Beijing Jeep have in fact declined, while nationally less favored firms such as Geely, BYD and Chery have grown.

1. By discriminating between firms of different size and ownership, they distort resource allocation. The "scale focus" of industrial policy works to favor larger firms. Given the greater role of SOEs at the "commanding heights" of industry, this implies a bias in their favor. The resulting over-abundant resource flows to (often less efficient) larger SOEs helped keep these firms alive while holding back SMEs. Furthermore, the scale orientation of policy can encourage Chinese firms to expand simply as a means of gaining policy support.
2. The frequent use of direct administrative intervention raises the level of uncertainty faced by non-favored firms, worsening their investment climate. Industries with long-term perspectives require a predictable environment for innovation, upgrading and growth. Firms that fear the unexpected imposition of direct regulation, forced or "encouraged" merger or even closure, will be more reluctant to invest.
3. The tensions created by competing policies of agencies across and within various levels of government further complicates doing business. Each actor can have very different objectives, even within a given level of government. The roles and responsibilities of each player are not clearly delimited, with overlap leading to confusion. The result is policies pulling firms in many different directions, with unclear net impact.

Compared with industrial policies, China's "industrial administrations" are more heavily criticized. In particular, the use of discretionary powers and the regulatory approval system can lead to rent-seeking and corruption, and worsen the business environment. Industrial interventions provide a basis for the close direct links between government and business. They have also been: (i) broad (affecting an unusually large share of the economy); (ii) often direct and intrusive; and (iii) applied by many players using many instruments (Jiang and Li, 2010; Shi and Wang, 2011).

D. Enterprise Sector Reforms to Achieve China's 2030 Vision

To generate the productivity gains and enhanced innovation which can underpin further rapid growth, and thus get China on a critical path for achieving its vision by 2030, China needs to:

1. Improve *technical* and *allocative* efficiency by restructuring the state sector and further enhancing competition between state-owned and private firms, especially by scaling back the state sector and tackling "administrative monopolies".
2. Improve *allocative* efficiency by further leveling the playing field, especially between small and large firms, and implicitly between state and non-state firms.
3. Meet new challenges and improve the business environment by moving to more limited, consistent, predictable and market friendly industrial interventions.

All three spheres of policy relate primarily to larger enterprises. While the agenda for enterprise sector and business environment reforms in China is much broader, the "commanding heights" of the economy offer the greatest potential for further efficiency gains, reduced imbalances and for limiting direct links between government and business.

1. Restructuring the state sector and enhancing competition between SOEs and non-SOEs

To begin tackling "administrative monopolies", the authorities could review the lists which give SOEs a privileged role in "strategic" and "basic and pillar" industries. In China, these lists are very broad. They include sectors which are rather open in most HICs, and where the rationale for state ownership is not obvious, especially as the state could achieve its objectives through regulation and law enforcement. If this review does identify sectors or sub-sectors for removal from such lists, the authorities could next identify and cancel the explicit or implicit barriers which unreasonably limit competition in such sectors. A clear signal could be sent that the evolution of such sectors will now indeed be on a level playing field. Such steps can be taken unilaterally without changes in the Anti-Monopoly Law. Where the rationale for state ownership is deemed strong, the focus could shift to strengthening the governance (boards and management) of such firms, and to their effective regulation (see below).

Such a review would be facilitated by a clear state ownership policy which addresses both short- and long-term issues in the state sector. Given the explicit or implicit (from force of habit) role of ownership in China's current industrial policy, this policy could include an elaboration of the envisaged role for SOEs in the economy. Such a statement could serve as a benchmark against which more specific policies would be measured.[38] In 1999, a CPC plenum tried to define the function of state ownership, listing four areas to be controlled by state firms: state safety, natural monopolies, public goods sectors, and important enterprises in pillar and high-tech sectors. However, this was not a clear state ownership policy, nor has it been well implemented. In 2006, SASAC declared that the state should have "absolute control" in seven sectors and "somewhat strong influence" in nine others. Going forward, the re-definition of China's state ownership policy should emphasize that state ownership should primarily focus on provision of public goods in non-contestable markets.

China could also make efforts to further downsize its state sector by a new round of SOEs restructuring. In the late-1990s, some Chinese economists called for a "strategic restructuring of the state sector" (Wu, *et. al.,* 1998). The 15th Congress of the CPC decided to carry out this strategy. However, its implementation seems to have been frozen in recent years after notable progress during 1998–2003. According to recent research (Zhang, 2010), state ownership is present in almost all competitive sectors. Even in wholesale trade, retailing and restaurants, 20296 SOEs still account for 17.8% of all SOEs. The downsizing of the state sector in the late-1990s and early 2000s was in reaction to serious financial distress. While ultimately successful, it came at a high cost of about 2 trillion RMB. To limit such costs going forward, further front-loaded SOE restructuring would ideally be more proactive rather than in response to crisis, and driven by the objectives of changing to the growth model to move to high income status. Without further downsizing of the state sector, it will be hard to create a fair competition environment for private firms and to limit the direct ties between government and business.

As the government ownership of enterprises is widespread and varied, covering most sectors and ranging from outright ownership to controlling interest to minority shareholder. The challenge for further SOEs restructuring is twofold: how can public resources be best used; and how can China best transition from its current approach to managing its portfolio of state enterprises to one that is best suited for its long-term development objectives.

The response to the first challenge is straightforward. Public resources should be used solely for the provision of public goods and services—the production or consumption of which result in unremunerated positive externalities. These can range from defense at one extreme to infrastructure, social protection, and basic R&D at the other—and the scope could evolve as conditions change. The recent emphasis on public housing for the poor is a good example of how government resources can be used to address a pressing social need. Indeed, the scope of public goods and services is quite broad, and can even include reliable energy supplies and the widespread availability of communications and postal facilities. The share of public resources applied in a particular area will depend on the nature of the public good or service being supplied. In areas considered to be of high national priority, like defense, government resources would be expected to provide the full or dominant share of finance. But in most areas, a smaller share is usually sufficient to achieve the government's objectives. Most importantly, in many

[38] The government can use state ownership as a policy tool to launch its industrial strategy, especially as SOEs can become excellent platforms for accumulating resources in times of economic prosperity. However, evidence suggests that a persistently large-size state sector can be harmful to efficiency and equitable competition in the long-term.

cases, private sector firms are fully capable of delivering public goods and services, even though the government may provide the bulk of the finance. The private delivery of public goods and services (with public financing) introduces the added dimension of competition and helps lower production and distribution costs.

The response to the second question is less straightforward. First, the government could securitize its implicit equity in state enterprises (in listed state enterprises, the value of the equity is already known) as soon as possible. This would pave the way for state enterprise reform by separating ownership from management and introducing modern corporate governance practices—appointment of senior management, public disclosure of accounts in accordance with international practice, external auditing, and so on. Second, the government could consider establishing one or more state asset management companies (SAMCs) that would represent the government as share holder and would professionally manage and trade these assets in financial markets where feasible. Each SAMC could specialize in certain sectors. They could then, on behalf of government, gradually diversify the portfolio and scale back state ownership over time. The dividends of state enterprises would need to be paid to the SAMCs who, in turn, would transfer them to the budget. Finally, a portion of state assets could be transferred to the national pension fund with the flow of returns being used to help meet future pension obligations.

While the operational details of the proposed SAMCs can be elaborated later, it is important that key principles are established early. It is critical, for example, that SASAC confine itself to policy making and oversight, leaving asset management to the SAMCs. The SAMCs should have clear mandates, be independently and professionally managed, and be subject to publicly announced performance benchmarks (depending on the nature of the enterprises in their portfolio). In addition, they will need to adhere to international standards for transparency, including on operations and results, value creation, profitability, and dividend payments.

In the *medium-term*, the expanded scope for private participation could be complemented by the restructuring of remaining SOEs. Building on China's own past experience with corporatizing and restructuring SOEs, more such large enterprises, especially those parent companies supervised by the central and provincial SASACs, could be restructured to mixed ownership enterprises and listed corporations. Furthermore, governments could reduce their ownership shares in those firms and build up modern governance featuring professional management. One additional benefit of narrowing the scope of the SOE sector would be to strengthen SASACs capacity to supervise its remaining SOEs.

Also in the *medium-term*, China could further spur competition by strengthening the Anti-Monopoly Law (AML) in two ways. First, it could further rein in "administrative monopoly" by making relevant clauses of the law clearer and more restrictive. China's new AML, enacted in 2008, devotes one chapter to administrative monopolies and their impact on competition, broadly declaring them illegal. However, in its current version, the law lacks teeth. The clauses are very simple and focused on the cross-regional trade in goods. Moreover, the current law is not actionable, leaving enforcement as a voluntary matter for "higher authorities". The relevant provisions are explicitly subordinate to other laws and regulations, almost guaranteeing that they will be overridden. Within government, application and enforcement is spread out across several agencies. Such a cautious approach could well make sense at the beginning. Given the importance of administrative monopolies, a law which made no mention of them would be incomplete. On the other hand, an overly ambitious approach (beyond the initial capacity to enforce) could also erode authority of the law itself. For example, the Antimonopoly Enforcement Agency would have to bring cases against other parts of government at same or higher rank. Clearly, enforcement of these provisions of the law will require both legal amendments and strong political will, including high level support to the enforcement authorities.

Second, the scope for exemptions from the law could also be reviewed. All competition laws grant exemptions or exceptions to particular industries and certain types of economic activities and/or transactions (UNCTAD, 2002). Exemptions may be sectoral in nature (e.g. to a true "natural monopoly") or functional, e.g. development of product standards or other practices where a single or few providers makes great sense. Some such exemptions might be necessary for furthering the objectives of competition policy. Other exemptions reflect pressures from special interest groups. In many cases, there is a clear need to revisit such exemptions. The UNCTAD report offers some general recommendations concerning procedures and principles for granting exemptions. After applying such principles, the number, nature and scope of exemptions will tend to be more limited and procedures more accountable and transparent.

2. Further leveling the playing field

Greater competition needs to go hand in hand with fairer competition. This would enhance allocative efficiency by helping direct factors of production towards their most productive uses. To this end, firms of different size or ownership should compete on a more level playing field, not only in a strict legal sense, but also in the terms on which they gain access to inputs.

The most promising *near-term* reforms to address this issue are outside the scope of competition policy, and would focus on directly tackling key distortions. These include: (i) the preferential access to credit by larger firms or SOEs, including due to moral hazard (see financial sector discussion below); (ii) the still low level of SOE dividend payments (which can leave savings within firms to be deployed less effectively than in other possible uses); and (iii) the implicit advantages which SOEs gain by their closeness to decision makers (including through the ministerial status of CEOs of large firms. A review of industrial policies (see below) to remove explicit or implicit biases in favor of firms of particular scale or ownership would also address such concerns.

In the *medium-term,* fairer competition could be promoted by developing and enacting a set of laws which would limit potentially distortive discretionary actions, including in the realm of industrial policy. By defining clear "rules of the game", such laws would be in the same spirit as the limits which the WTO places on its members' trade policies, or which the US Constitution places on restricting inter-state commerce. Such rules could contain some of the most egregious attempts by central and sub-national officials to pull in different directions using crude administrative means. One such law is the AML, which has already been discussed. If this strengthened AML still left important gaps, it could be complemented by additional legislation (possibly in the form of a special law) to restrict currently widespread industrial interventions by central or sub-national governments. This law should be actionable, with any governmental departments liable to be charged if they impose interventions restricted by the law.

In the *longer-term*, to safeguard fair competition in a single market, China could consider enshrining limits on the financial support which its governments can directly or indirectly provide to firms. One recent example is large capital injections into major state-owned airlines (Pan, 2010). By allowing some firms to absorb losses that a purely commercial entity would not or could not absorb, such support results in unfair competition. To counter such tendencies, China should provide its governments with clear rules of the game in dealing with inevitable pressures for aid of one form or another (Leipziger, *et. al*, 1997). This could build on experience of the European Union (EU) in implementing rules on "state aid". While the EU and China have many important differences, they face similar problem of regulating anti-competitive behavior either by member states (in the EU case) or by sub-national authorities (in China's case). EU experience emphasizes the necessity of a credible institutional framework to monitor industrial subsidy programs and enforce mutually agreed on rules for industrial policy.[39]

[39] See Schneider (2010) for a detailed discussion of EU "state aid" rules in the Chinese context.

3. Focusing and modernizing "industrial policies"

China's industrial policy needs to adapt to changing circumstances. In the context of the catching-up oriented industrialization of the past 30 years, while such policy did not always work as expected, it may have at times played a positive role. However, China's current system of industrial interventions could become an obstacle to achieving the innovation-driven growth to which the country now aspires. In distilling lessons of East Asian industrial policy, Weiss (2005) notes that for higher income emerging economies, the agenda will be to upgrade export structure and move up the value chain. For these economies, old style industrial policy of "second guessing" the market and creating winners will have less relevance. This will require a business climate which is more favorable to SMEs and new entrants, which encourages fair competition, which is more tolerant of low sectoral concentration and excess capacity, and which relies more on market mechanisms. The type of innovation which China seeks to unleash can initially result in rash new entry, ferocious competition, fragmentation, and excessive investment, developments which need not be unhealthy in industries which have yet to mature.

Reform of industrial policy should start from a clear elaboration of its role and purpose. Which market failures, externalities or other circumstances need to exist for such policies to be applied? As Leipziger *et. al.* (1997) note, governments which follow a "hunch" to support a particularly prestigious industry without clear evidence of a market failure, or those which identify favored sectors based on non-economic criteria, will impose a high fiscal cost and generally fail. Such principles could be published to ensure transparency concerning policy objectives and the monitoring and evaluation of results.

Based on this clear elaboration, policies themselves would be more focused, implemented by fewer actors, simpler, and more market-friendly. As noted above, China's current industrial interventions can be extensive, inconsistent, unpredictable, and administrative. Greater focus means limiting their application to a few sectors where the case for such policies is strongest. This would avoid spreading scarce technical and entrepreneurial talent too thinly and crowding other established sectors with comparative advantage out of input and factor markets (Westphal, 1990). The involvement of fewer actors (see below) would add coherence to policy. A more limited set of admissible interventions, including the provision of any support through fiscal rather than banking channels, would promote greater transparency and reduce collateral distortions in other markets (Leipziger, *et. al.,* 1997). For example, pursuit of more general objectives, e.g. concerning consolidation of a sector, without prejudice towards specific (incumbent) firms, would avoid discrimination against potentially more innovative new firms. Support should be temporary and subject to strict "sunset clauses". The selection mechanism should lean towards innovation ability instead of scale and ownership. Finally, policies should try to work with the market, harnessing its power to achieve desired aims, rather than against it. For example, using market forces to spur mergers and acquisitions (e.g. by making more shares tradable) would promote concentration without prejudicing its outcome.

China's unique size, complexity and high degree of decentralization should also affect the form of its industrial policies. Specific approaches which may have worked well in smaller and more centralized economies such as Japan, Korea and Singapore could be problematic in China. With multiple layers of government possessing significant *de facto* autonomy, the central authorities could formulate policy but find it very hard to monitor or enforce. Within a given level of government, numerous agencies with overlapping mandates can pull in different directions. Local governments seeking to generate new jobs or tax revenues will have clear incentives to protect existing enterprises or attract new ones. This could be done by providing resources such as land at a steep discount, by helping navigate the required permits/approvals, or by hindering or blocking cross-border mergers. Such forces can exacerbate industrial fragmentation, frustrating central government efforts to consolidate.

Changes in tax sharing rules and in performance evaluation of local officials can help better align their incentives with national priorities. To the extent that local industrial policy is motivated by the desire for more revenues, different sharing rules for key taxes (esp. VAT) might reduce incentives for fragmentation. Similarly, performance evaluation which goes well beyond indicators of local GDP growth could limit excessive desire to attract or preserve industries in need of consolidation. All of this is a matter of degree, as competition among sub-national units has also had positive features, and those features should be preserved. Any deeper realignment of incentives would require more fundamental changes to the relationship between levels of government in China, which we do not consider here.

Finally, as a general issue cutting across the themes discussed above, the assignment of functions related to ownership, policy and regulation across government agencies needs to be rationalized. As a result of individually sound but piecemeal reforms, China now has a range of agencies with multiple and overlapping functions. For example, in addition to its core function of supervising state ownership in SOEs, SASAC also retains certain regulatory and policy-making roles. Similarly, responsibility for enforcing the AML is split between three agencies with other broader responsibilities—SAIC, MOFCOM and NDRC. For example, MOFCOM is charged with encouraging FDI. Some SOEs even retain responsibilities for sector policy while also seeking to earn good return, e.g. tobacco. This compounds already severe fragmentation across levels of government and tensions between various stakeholders. Such fragmentation can lead to a blunted focus, duplication of efforts, conflicts of interest, and weakened responsibility.

Going forward, China could review current functions and responsibilities, reallocating them so that one body would be the lead (if not sole) agency in a given area. For example, SASAC would focus entirely **on the narrow mandate of "maintaining and increasing the value of public assets".** As in most OECD countries, a single government body would implement and enforce competition policy. A third agency (e.g. NDRC) could take sole charge of industrial policy. Enterprises would be charged with doing business. Focused bodies will individually be more effective and work more coherently together. There has been some progress in establishing separate sectoral regulatory bodies—this needs to continue.

The performance of China's enterprise sector can also be improved by other reforms beyond the realm of industrial policy. These include issues on the general business climate, remaining barriers to a deeply integrated single national market, strengthening intellectual property rights, public procurement reform, contract enforcement, bankruptcy regimes, and trade policy, improving access to finance and strengthening corporate governance.

Chapter 5 Financial System Reforms

A. China's Financial System Developments to 2010

The Chinese financial system has served the purpose of savings mobilization and capital allocation to strategic sectors during the catch-up stage of economic development. It was successfully transformed from the socialist fund allocation system to a system that has proved effective for financing a rapid expansion of investment and thereby economic growth during the last three decades. The banking system has mobilized sufficient national savings to meet high investment demand by firms and local governments. Its extensive branch network, perceived stability by depositors in state owned banks, reasonably stable inflation, and high household savings rate, among other things, have contributed to this successful role.

The past decade has also witnessed important progress in reforming and restructuring the financial system. There has been progress in interest rate liberalization. Reforms in the governance of state owned commercial banks (SOBs) were introduced by selling a portion of shares to strategic investors and listing them on domestic and foreign exchanges. Entry restrictions on financial institutions and controls on capital flows were somewhat eased. Important regulatory reforms were undertaken by institutional restructuring and introduction of global standards. Various measures were introduced to boost the development of securities markets.

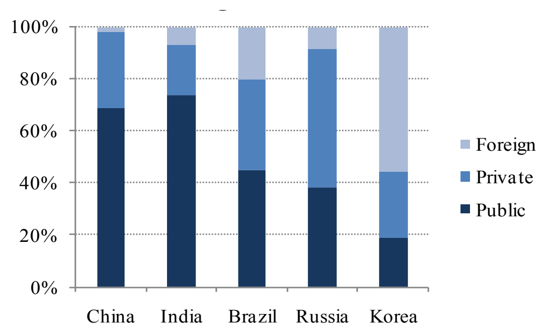
Despite the many reforms introduced so far, the Chinese financial system remains repressed, unbalanced, costly to maintain and potentially unstable.

- **Repressed.** Pervasive controls remain in key areas.[40] The levels of state ownership in the banking sector (Figure 6) and government intervention in the financial system are much higher than in other countries at a similar stage of economic development that later achieved high income status. Despite changes in the ownership structure of SOBs from the previous system of exclusive state-ownership to the current system of joint-stock ownership, the government continues to dominate in the financial sector. Continued protection and intervention in the businesses decisions of financial institutions make them convenient policy instruments, the use of which prolongs the bureaucratic culture and distorted incentives that have prevented banks from full commercialization and from allocation of financial resources to the most productive uses.
- **Unbalanced.** Despite recent efforts to promote direct financing, bank credit still accounts for close to 90 percent of funds raised by the corporate sector. While it is not uncommon for financial systems to be weighted toward banks at China's stage of development, international comparisons show that China's is especially so (Figure 7 and Annex 4). Recent research indicates that the optimal financial structure becomes more market-oriented as economies develop (Demirguc-Kunt, Feyen and Levine; 2011). This is consistent with theoretical arguments that economic development increases the demand for the services provided by non-bank financial institutions (NBFIs) and the securities markets relative to services provided by banks. The histories of developed countries such as Britain, Germany, Japan, and the US also indicate major complementarities in the functioning and development of banking systems and securities markets (Allen, Capie et. al., 2011). So far, China has not taken full advantage of these complementarities. If the histories of high income countries are a reliable guide, its future development likely hinges on achieving a more balanced financial system. Additional imbalance is found in the capital market in which the share of fixed-income market is overwhelmed by the equities market and the share of corporate bonds market remains small.

[40] Controls are in the form of directed credit and aggregate credit ceilings; floor for loan rates and cap on deposit rates; and business decisions of financial institutions.

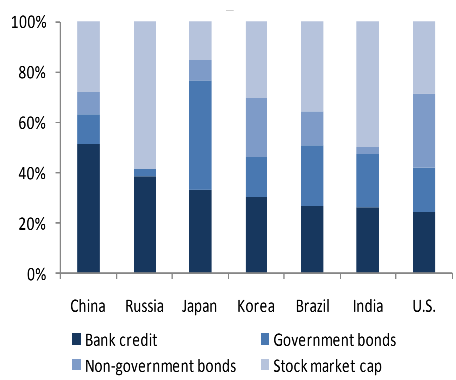
- **Costly to maintain.** The financial system is exposed to accumulated losses yet to be fully absorbed and new losses in the making. Banks have been used as instruments of the government's macroeconomic and sectoral policy goals and have not always been in a position to lend prudently. While this may have facilitated accomplishment of policy goals, it has also exposed banks to a greater risk of deteriorating loan portfolios, increasing the ultimate costs of such public policies. Rounds of capital injections into SOBs and disposal of non-performing loans at the end of the 1990s and prior to public listing of their shares, not to mention the reported losses on lending to local governments incurred since 2008,[41] are indicative of the magnitude of real and potential costs to the government budget.
- **Potentially unstable.** The financial system is fragile and vulnerable to potential instability for several reasons. Systemic risks are embedded in the homogeneous behavior and operations of financial institutions—in part reflecting weak commercial orientation; in the widespread financial services integration and conglomeration that has been going on for years without a strong regulatory framework to monitor, measure, and mitigate risks across the financial services industries; in the rapid growth of shadow banking activities that, while providing useful channels to those underserved segments of the economy, are largely out of the official oversight; and in the large overhang of local government debts as mentioned earlier. A major component of the financial safety net—the deposit insurance scheme—has yet to be created more than 10 years since its initiation. The mechanism for resolution of troubled banks has not been institutionalized and crisis management mechanisms are not well established. Lack of information sharing and coordination among the fiscal, monetary, and financial regulatory authorities, and limited progress in building up a macro-prudential framework against systemic risks, are also causes for concern.

FIGURE 6 Ownership structure of the banking sector, 2005



Source: World Bank Financial Regulation and Supervision database.
Note: The figure shows the share of banking sector assets held by majority-foreign, -private domestic, and-state owned banks

FIGURE 7 Financial system structure in comparison, 2009



Source: BIS, CSRC, IMF International Financial Statistics, WDI

Overall, financial sector reform and development have been out of step with the real economy. The current financial system, characterized by bank dominance and strong state intervention, has served the purpose of savings mobilization and capital allocation to strategic sectors during the economic take-off, but such benefits are increasingly outweighed by the costs of the accompanying distortions and the resulting buildup of imbalances and risks. China could conceivably sustain high economic growth for a while longer even without fundamental reforms in the financial sector. However, in such a case, distortions in resource allocation would be

[41] According to media reports, the potential losses of banks lending to local government platforms may be in the order of 2 trillion yuan.

intensified, income and wealth distribution worsened, and internal and external imbalance sustained. This would undermine social stability, slow productivity growth, and erode competitiveness. The potential debilitating effect of a future forced financial liberalization, and lack of an integrated approach and concerted actions on the part of the government can only serve to exacerbate the negative consequences. Now is the time for China to rethink its vision and strategy in the financial system, to avoid a situation where delays in financial system reform and development disrupt or impose a drag on the real economy.

B. China's 2030 Vision for the Financial Sector

China needs to build a more liberalized, balanced, efficient, safe and sound financial system that meets the demands of corporate, household and government sectors. China's future financial system should be free of repression and strike a balance between the banking and non-banking financial institutions and markets, especially the capital market, with more diversified institutions and products reflecting the changing nature of China's economy. Financial institutions should be commercialized and rationalized, through installation of effective corporate governance, creating a level playing field, establishing effective oversight, and subjecting to bankruptcy regardless of ownership structures. The financial system should have better outreach to households, consumers, micro, small and medium enterprises (MSMEs), and be able to provide long-term/risk capital to support the upgrading and expansion of incumbent firms and the emergence and growth of new firms in high-tech and emerging industries.

A well functioning financial system is essential in China's drive to become a harmonious and high income society. First, as growth in the supply of labor and capital slows, China will have to rely more on productivity growth which has to be supported by the financial system through improved allocation of capital. Second, the increasing importance of TFP in supporting economic growth requires innovation which cannot be realized without support from the financial system, especially a well developed capital market. Third, a well functioning financial market could provide reliable monitoring and corporate governance, and facilitate timely industrial restructuring via the entry and exit of firms through various paths including M&A. Fourth, the need to rebalance the Chinese economy will require an inclusive financial system that provides widespread access to diverse financial services and products by households and MSEs. Fifth, finance also contributes to preparing old age security, reduction of poverty and inequality by improved opportunities for households to borrow and invest in assets whose value can grow in parallel with the economic advancement of China. Finally, finance can be disruptive to economic development if not managed well, as shown in the recent financial crisis and China's own experience.

C. Key Reforms to Strengthen China's Financial System

Building a more efficient and robust financial system that can well serve China's transition toward a modern, harmonious, creative and high income society will require a systematic approach to reform. In order for the system to embark on a virtuous cycle, it will be critical for the government to gradually reduce its influence in the internal affairs of the financial institutions to focus on roles that belong to the government, including regulation and supervision and infrastructure building, as well as creating and enforcing the right incentives and mechanisms.

1. Full commercialization and rationalization of the financial system

Macroeconomic and financial policies and instruments need to be better aligned to create incentives for a lasting transformation to a more commercially oriented and effective financial system. Mechanisms, structures and institutions must be created that provide financial intermediation without distorting incentives, exacerbating moral hazard and creating contingent liabilities for the government. To facilitate this process, the government should continue to reorient its roles and responsibilities, moving from direct controls to indirect measures. As an example, important monetary policy decisions are currently made by the State Council. Thus, the central bank does not have the necessary independence to carry out its functions. Monetary policy has been conducted through frequent change of reserve requirement ratios, window guidance and even credit ceilings. To enable banks to better manage their assets and liabilities, the central bank could conduct monetary policy in more market friendly ways, i.e. via open market operations.

It is important to move away from direct or indirect control of financial institutions and to develop alternatives to bank-based funding of government policy goals. The government at all levels has been closely involved in the commercial operations of financial institutions, either through holding of shares or indirect influences, mainly because it is heavily dependent on the use of commercial bank credit for policy goals. Full commercialization of financial institutions will not be possible unless this practice is replaced by other mechanisms, including greater use of direct fiscal expenditures, government credit programs that work through the banking system, rationalization of policy banks, and reforms to intergovernmental fiscal relations. The goal should be to first free the commercial banks from policy-oriented functions to enable them to compete with their peers from home and abroad, by subjecting them to market discipline and effective regulation and supervision. Policy loans and government directed loans could be gradually phased out or transferred to those few policy-based banks with clear mission and mandates and operate under strictly enforced performance monitoring and evaluation.

A commercially oriented governance system should be introduced. While privatization would be the best way to make SFIs more commercially oriented, privatization of the big SFIs would not be easy.[42] Since the government is likely to remain majority owner of the SOBs, state ownership functions need to be strengthened. To be effective, state ownership agencies need to act in ways similar to private owners. Otherwise, given the multiple objectives of the government, SFIs will not become truly commercialized. China may introduce a governance structure of banks by a thorough stock taking of the existing state ownership functions, agencies and practices, and drawing lessons from international best practice and failures (Box 10).

[42] It would be hard to find domestic strategic investors. Selling them to foreign strategic investors may not be politically acceptable, and it might be difficult to find willing and able buyers for a variety of reasons. Privatization by placement of government shares to small individual investors would not be a good option either, as the government would continue to be able to control the bank's management and operation.

BOX 10 Improving the effectiveness of the state ownership functions (SOFs) in the financial sector

China has yet to establish consolidated and effective SOFs in the financial sector. While the Government has stated its intention to remain a dominant owner of key SFIs in the long run, there has never been a clear elaboration of why direct ownership is necessary for achieving its objectives. Many organizations are involved, each with responsibility for only a small aspect of ownership. None has either the perspective or authority to take a broad view of the financial sector. Fragmentation leads to both ambiguities over decision making authority as well as mismatches between rights and responsibilities. Moreover, there is insufficient public information on how the state ownership in the financial sector is organized, let alone about the objectives, mandates, division of rights and responsibilities, and performance indicators. In this setting, a meaningful monitoring and evaluation framework is not possible.

Several reforms are needed to further improve the effectiveness of the SOFs. The government needs to spell out the long-term and overarching goals of the financial sector, explain why it needs to own financial institutions, decide on which institutions should continue to be held and which should be let go, and determine what level of ownership should be maintained over what period of time and how it should be done. The rights and responsibilities of State Ownership Agencies (SOAs) need to be clarified in the law. An ownership policy should be developed and published to inform the general public as to why the government intends to own specific institutions and how its rights will be exercised and ownership responsibilities distributed and carried out. Transparency and accountability can be enhanced by implementing a performance monitoring system and developing aggregate reporting on the performance of portfolio SFIs. In the medium to long run, a rational SOF organizational format should be considered. However, mere organizational changes can fail to achieve the intended results if not accompanied by fundamental changes in incentives and institutions.

2. Further liberalizing interest rates

China has reached the stage where it needs to phase out remaining interest rate controls. Much progress has been made in liberalizing interest rates, but the remaining controls have been blamed for many distortions in the financial sector.[43] Such controls have played a key role in the overall strategy of catching up through strategic capital allocation to priority sectors, and protection of the banking system. However, as the economy matures, the remaining controls become a drag on growth as artificially cheap capital contributes to overinvestment and delays restructuring. It has also hindered the development of capital markets due to distorted risk pricing. The guaranteed interest spread has prevented the formation of a true risk culture, which is key to commercial banking, capital market development and access to finance. In addition, market determined interest rates will be crucial for an effective movement of monetary policy from direct quantitative control to indirect control.

While the floor for lending rates is easier to remove as it has become unbinding, liberalization of deposit rates is a complex matter, requiring several key prerequisites that cannot be ignored. Too rapid disintermediation or too rapid inflow to short-term financial products could raise the risk of financial crisis. There will also be a need to avoid a significant asymmetry in the pace of liberalization between banks and NBFIs, and between the direct market and indirect market. The moral hazard of financial institutions needs to be properly checked to prevent destabilizing interest rate competition. Effective regulation to prevent excessive competition

[43] Financial institutions continue to be subject to a floor of lending rates and a ceiling on deposit rates. The cap on deposit rates has been circumvented to a certain extent by the newly emerging credit-based wealth management products in the banking system, which further exacerbated the situation of shadow banking, with potential negative implications for financial stability.

for deposits by bidding higher rates and making loans to risky borrowers at unduly high rates should be secured prior to liberalization of the relevant bank interest rates.

3. Deepening the capital market

Deepening the capital market is conducive to a re-balancing of the financial structure and to the catch-up strategy of innovation in science and technology in which innovative, vibrant private firms could emerge and thrive. A country's financial structure impacts the types of industries that get financed, with equity finance supporting more innovative industries and debt finance through bond issuance and bank lending being better suited to existing industries. A key advantage of capital markets relative to banks stems from the fact that multiple potential investors evaluate business opportunities, which can help assess the viability of new technologies. Venture capital and private equity industries will have to play a bigger role in financing technologically advanced industries. Institutional investors will also play an increasingly important role in the development of China's capital market. Deepening capital market will also help to increase the access to bank loans by households, MSMEs as large and established firms rely more on direct financing.

A market-based financial system is more dependent on the rule of law and market infrastructure than a bank-based system. An equitable, transparent and efficient capital market is not achievable without a fundamental reorientation of the role of government. The authorities should gradually reduce administrative controls where market mechanisms could do better. As an example, China should move to a disclosure-based system from the current merit-based approval system in IPOs. The government should focus on improving the legal framework, enforcement of laws and regulations, upgrading financial infrastructure, and imposing stringent rules on information disclosure. Artificial segregation of the market should be avoided. The current segmentation of regulation in the fixed-income market among the PBC, CSRC and NDRC raises concerns about regulatory inconsistency. Their respective roles should be clarified to ensure regulatory consistency among different market segments.

Growth of asset management business is essential to facilitate the deepening of the securities market. China's financial system needs to provide a reasonable variety of financial products with different risk/return profiles to meet different risk preferences of investors. Risk-averse individuals can choose bank deposits, while more risk taking investors may purchase corporate bonds, mutual funds and stocks. This would facilitate the flow of funds to risky entrepreneurial ventures with potentially high return and long term corporate investment with a long gestation period. The growth of asset management business could also assist in providing greater financial security for the elderly (i.e., improved vehicles for accumulating retirement savings) and, more broadly, for securing social cohesion and stability. Asset management requires less strong regulation than banks, but it requires transparency, strong investor protection, market determined interest rates and mark-to-market of assets. The government has to provide a solid legal basis to nurture this business. According to other countries' experiences, once the market infrastructure and environment is provided, this business can grow quickly, taking a large part of household and corporate savings.

4. Upgrading financial infrastructure and the legal framework

Financial infrastructure needs to be further upgraded to facilitate the financial market in general and the capital market in particular. Financial infrastructure includes many elements, such as credit information systems, rating services, accounting and auditing, payment and securities settlement systems, exchanges and OTC markets. While many key elements are formally already in place, more needs to be done to ensure their effective functioning. As an example, great strides have been made in the past few years in China's security interest filing system, as demonstrated in the registry system for accounts receivable and lease interest registry. What remains to be done is in the registration of inventory and equipments which should be centralized and internet-based in order for it to be working. In addition to the enhanced payments and securities settlement system, efforts may include continuing to improve the coverage and quality of the consumer credit information reporting as well as improving the independence, and professional ethics and standards of credit rating agencies.

Adequate and accurate disclosure and transparency supported by credible accounting and auditing practices can go a long way in supporting financial development by minimizing informational frictions. China's legislative and regulatory framework on accounting and auditing has converged to international standards.[44] However, reviews and anecdotal evidence point to noncompliance in some financial statements of listed companies and variations in the level of compliance with applicable auditing standards. More seriously, fraudulent activities can cause reputational damages and loss of investor confidence that is hard to restore. More efforts are needed to further strengthen the capacity of the regulators, as well as to improve the development of accounting and auditing professions. Strong and strict penalties should be imposed on improper accounting and auditing practices.

5. Strengthening the regulation and supervision framework

The independence and effectiveness of regulatory and supervisory bodies can be enhanced. Achieving this is a challenging task, especially because the government role as both an owner and regulator of major financial institutions creates potential conflicts of interest. Almost without exception, the experiences of other countries in a similar situation bear out the failure of regulatory oversight. The risk of failure becomes greater as financial liberalization progresses and competition in the financial market deepens. China's integration in the international financial system and the internationalization of the RMB will put pressure on China to improve its regulation and supervision. The government needs to seek institutional reforms to secure the political independence of regulatory bodies to enable them to conduct arm's length regulation and supervision, regardless whether it would remain the owner of financial institutions.

Institutional arrangements are needed to better align regulatory resources and structure to deal with increasing integration of the financial services industry. In spite of laws that insist upon segregation among banking, securities and insurance in the financial sector, the degree of financial conglomeration is stunning. The existing regulatory and supervisory structure does not provide the necessary monitoring and surveillance to deal with the spillover of risks among financial institutions and industries, as the coordination mechanism is perfunctory and information sharing is sporadic. The authorities may be forced to decide whether to unify all financial regulators under one roof, or to maintain the current regulatory architecture but strengthen their ability to deal with cross-industry financial risks, probably through improved functional supervision.

A well-defined and functioning macro-prudential framework is critically important for China to prevent and mitigate disruptive idiosyncratic risks, including those that may well emerge from the rapid growth of shadow banking activities. At present, there are some forms of interagency coordination on broad financial sector issues, but a comprehensive macroprudential framework needs to be developed, with clear institutional setup (including mandate, powers, distribution of responsibilities, information sharing arrangements, etc.)the PBC is deeply involved in *micro*-prudential regulation and supervision, as evidenced by the *differentiated* approach to required reserve ratios and capital requirements,[45] and tight control of the inter-

---

[44]The new Chinese Accounting Standards have achieved material convergence with the International Financial Reporting Standards (IFRS). The Chinese Standards on Auditing are also largely comparable to the International Standards on Auditing (ISA).

[45]The practice of differentiated reserve requirement and differentiated capital regulation would require bank-specific information that is only available to the banking supervisory authority gathered through its off-site

bank market participation and operations. The financial regulatory authorities are reluctant to retreat from areas pertaining to *macro*-prudence while not focusing fully on *micro*-prudential regulatory and supervisory work. While the concept of macro-prudential regulation is yet to be fully defined in China, its importance for securing financial stability is being emphasized globally.

China could establish a high-level financial committee on the basis of the existing framework, with the main objective of reducing systemic risk and maintaining financial stability. Such a Committee, if endowed with strategic significance and charged with forming an overall assessment of the financial system, would not only free the State Council from its current heavy burdens, but also enable sector supervisory authorities to concentrate on improving the effectiveness of financial regulation and supervision. It would also remove obstacles between the central bank and various supervisory bodies in coordination and information, and analyze and supervise all institutions, products, instruments, markets and transactions that might bring about systemic risks. The role of this financial committee could also include development and establishment of instruments, standards and indexes for systemic risk monitoring and identification, and development of *macro*-prudential instruments (possibly using *micro*-prudential means as transmission channel).

6. Building a financial safety net, developing crisis management and insolvency schemes

Financial liberalization will lead to a more efficient financial system but also increase the risk of financial instability. Most countries have faced big or small crises in the process of opening their financial systems, often as a result of macroeconomic distortion and volatile changes in relative prices and asset values. While China's huge foreign reserves give it a strong buffer against a possible currency crisis, it cannot neglect the possibility of a domestic financial crisis.

An early warning system would be helpful for effective oversight, early intervention and prevention of financial crisis. To identify threats, the authorities need to continue to deepen their financial stability analysis and develop a full range of early warning indicators. This warning system can be composed of two parts. The first is a set of macroeconomic and sectoral models, possibly encompassing the housing market, foreign exchange market, banking sector, stock market and labor market, among other things. It can specify the range of daily, weekly, and monthly changes in indicators that would dictate the severity of supervisory reaction. The second part is to define the institutions responsible for monitoring and reporting market developments, and making decisions to address specific developments.

China should create an insolvency regime for the financial sector that would allow for an orderly exit of weak or failing financial institutions. In China, "too big to fail" or "too connected to fail" is deeply rooted in the state ownership and control of financial institutions. Even small financial institutions that fail to pay off their debt rarely go bankrupt.[46] This creates the potential for rampant moral hazard. Signaling in an early stage of liberalization that poorly managed banks and firms could go under would be necessary even if it entails substantial short run cost. Such a regime would include the designation of a resolution authority; the legal power to intervene promptly in a nonviable financial institution; resources to close, recapitalize or sell such an institution; capacity to manage the intervened institution, including its assets; and an effective safety net. A well functioning insolvency regime would help contain moral hazard

surveillance and on-site examination. It would be logical for PBC to focus on core central banking business and macro-prudential functions instead and leave micro-level prudential matters to the banking supervisory authority.

[46] In the past decade or so, only one bank, Hainan Development Bank, was closed. Several dozens of minor financial institutions, mainly credit cooperatives, have been allowed to go under, but their resolution has been lengthy.

and also protect fiscal soundness. The authorities should establish an effective exit mechanism in the legal framework and streamline the court system to deal with troubled banks and firms in a timely fashion. It should allow for an orderly exit of weak or failing financial institutions and a clear definition of the role of the government in providing fiscal support. The roles of PBC and regulatory agencies need to be reviewed. For example, it is important to limit central bank emergency liquidity support to solvent banks facing short-term liquidity problems, and to establish an out-of-court settlement system while streamlining the court system to resolve quickly failed financial institutions.

A formal deposit insurance scheme is needed to deal with potential bank runs on privately-owned depository institutions and to protect the savings of small depositors (Box 11). The tendency to establish a deposit insurance fund instead of a multi-function deposit insurance system requires careful consideration. If such an institution becomes a fund only to pay for bank failures, it will bear the loss from risks incurred by banks with no ability to curtail those risks *ex-ante*. Experiences from other countries show that deposit insurance institutions need to have some means to curtail the moral hazard associated with bank risk taking, sometimes involving a supervisory role, to better align their compensation rights (i.e. premium paid by banks) and obligations (payments to insured depositors) in the event of bank bankruptcy. Otherwise, the advantages of deposit insurance, such as deterrence of reckless risk taking by banks and improving the stability of the banking system by decreasing the probability of bank runs, are lost. Secondly, it is important to provide a legal basis for deposit insurance institutions to carry out their duties. The proposed "Regulations on Deposit Insurance" tries to solve problems through administrative regulations rather than legislation.

BOX 11 Establishment of a deposit insurance scheme

A set of principles has emerged from cross-country evidence on the creation of an effective multi-function deposit insurance system. First, and most importantly, coverage should be limited so that large depositors, subordinated debt holders, and correspondent banks are convinced that their funds are truly at risk. This creates strong incentives for a relatively sophisticated set of depositors to monitor the activities of banks, while at the same time providing assurances of safety for depositors of smaller amounts of savings who generally lack the ability to effectively monitor banks. Second, membership in the deposit insurance scheme should be compulsory, so that stronger institutions cannot select out of the pool when new funds are needed to cover losses by other banks. Third, joint public-private management of deposit insurance schemes has proved more effective than either solely private or public management.[47] However, in Asia, deposit insurance schemes have tended to be both publicly managed and have non-compulsory membership. Fourth, it must be made clear that funds to cover bank losses will come principally from the pool of surviving banks, and that taxpayers will be tapped only in truly catastrophic circumstances. Fifth, deposit insurance premiums should be actuarially fair for the risks taken by banks, though in practice they tend to be lower in many countries (Laeven, 2008). Sixth and finally, deposit insurers must play an active role in decisions about when and how to resolve a troubled bank, to minimize the cost of resolution and protect the remainder of the deposit insurance fund. Evidence shows that banks are less likely to become insolvent when the deposit insurer is responsible for intervening failed banks and has the power to revoke a bank's membership in the deposit insurance scheme (Beck and Laeven, 2008).

An effective crisis management framework should be put in place. China has come out of the financial crises of Asia in 1997 and the recent financial crisis of 2008 largely unscathed. But that should provide no reason for complacency, as the Chinese financial institutions have been untested and are not immune to external and internal shocks. A framework for crisis

[47] However, there are very few cases of solely private management, so the evidence here is based mostly on a comparison between joint public-private management and solely public management.

preparedness should be put in place by consolidating the various existing standalone arrangements and blocks, including financial projection modeling and contingency planning and involving all the relevant agencies. Strategic design and capacity building are both key to the successful function of such a framework.

7. Recasting the rights and responsibilities of government

Most existing problems and potential risks in China's financial system could be traced back to the functions of government. An important distinguishing feature of China's financial system is the extensive involvement of the government in financial market activities. As mentioned earlier, the government acts as owner and regulator of financial institutions and influences resource allocation through direct and indirect controls. The government is also widely perceived as an implicit guarantor of financial institutions. Despite the perceived advantages of government involvement and domination in the financial system, the negative impact on the financial sector has become increasingly felt: the conflicting roles of government in ownership and regulatory functions have made it impossible for regulation and supervision to be truly effective; continued patronage of financial institutions, including through appointment of senior executives, has prolonged the bureaucratic culture among banks; and the perception of implicit guarantor of failed financial institutions has exacerbated moral hazard, just to mention a few examples. To establish an effective financial system and ensure financial stability, China needs to reorient the rights and responsibilities of government in the financial sector.

First, the government should put more emphasis on creating an environment conductive to finance. The government could invest in financial infrastructure, allow the SFIs to price their services and products without interference, promote entry and impose discipline on failures. A combination of conducive financial policies, enabling financial infrastructure, a reasonable degree of competition, and the threat of bankruptcy will go a long way towards bringing down transactions costs and providing the right incentives for SFIs to step up efforts to provide convenient, rapid and reliable financial services.

Second, the conflict of interest caused by the multiple roles of government as owner, supervisor and promoter should be resolved. Such conflict of interest makes it difficult for the supervisory authorities to carry out their roles in a neutral and just manner, and thus to take decisive actions in case of serious offence. Besides, the regulatory authorities in China are deeply involved in the governance and operations of financial institutions through the power to appoint and remove top-level managers.

Third, the rights and responsibilities of local governments need to be aligned. Although local governments bear the responsibility for the financial failure of local financial institutions, they do not have relevant supervisory mandates and capabilities. Consistent with the overall trend toward decentralization, the central government increasingly granted authority to local governments, especially since the late 1990s. There are more than a dozen types of (quasi) financial institutions under the administration of local governments. However, supervisory functions for these institutions are scattered across different departments. Lacking the means and capacity to ensure the safety and soundness of local financial institutions, provincial governments can resort to heavy intervention in their governance and operations, either through the provincial RCCU or through the Financial Affairs Office, or *Jinrongban*. In actuality, the provincial governments have assumed an ownership role in local financial institutions, at the expense of pursuing their regulatory functions.

In this regard, there is a need to establish an effective provincial-level financial supervisory framework. Local governments should focus on exercising their supervisory responsibilities, maintaining effective coordination with central government supervisory authorities and gradually establishing regional supervisory capabilities, including establishing a supervisory framework, training a professional supervision team, and strengthening the effectiveness of on-site examination and off-site surveillance. Better provincial-level financial supervision will not only alleviate the supervision burden of the central regulator, it will also fill the vacuum and ultimately reduce regional financial risks. In order to establish such an effective regional financial supervisory framework, local governments should gradually separate the responsibilities of ownership and supervision.

Fourth, the government needs to define and effectively provide non-commercial financial services. A clear line between policy and commercial activities would determine what services and products shall be provided by the government or by financial institutions owned by the government. In cases where policy-related finance is justified, there should be clearly set principles and policies, supported by performance monitoring and evaluation. An exit strategy is also needed to avoid prolonged use of public resources and potential distortion of credit markets. All this will allow commercial financial institutions to focus on their commercial business, improving the effectiveness of capital usage and avoiding both financial and fiscal loss. A good understanding of the commercially sustainable frontier is essential for further reform in the policy banks and the promotion of inclusive finance to rural households and micro and small enterprises.

D. Obstacles and Triggers

Obstacles to reform

The main obstacles to reform or difficulties faced in the process of financial liberalization are those commonly found in a financial system which has been dominated by SOBs and/or strongly intervened by the government for a sustained period. The concerns over these obstacles tend to delay the reforms while there would be need to meet the changing internal and external economic environment.

- **Moral hazard of SOBs and SOEs.** In a situation where major banks and firms are owned by the state, moral hazard can be pervasive. Without hard budget constraints, firms would continue to engage in reckless investment and borrowing which would lead to continued high demand for credit despite increased interest rates. Banks which put higher priority on gaining market share than on profit and prudential management would drive interest rate competition. Weak banks would have especially big incentives to offer higher deposit rates to mobilize funds and lend or invest them in high risk borrowers or projects. This can lead to widespread distress borrowing and financial instability. If the strong incentives for moral hazard are not properly checked, interest liberalization, and financial liberalization more generally, may invite a high risk of financial instability.
- **Financial weakness of some SOEs.** Currently, SOEs pay much lower average interest rates for their debt than other borrowers such as private firms and cooperatives. The weighted average return on assets (ROA) of SOEs is also significantly lower than that of other firms (see previous chapter). On the other hand, the average debt/equity ratio of SOEs is substantially higher, exceeding 230%.[48] If the financial system is liberalized, many highly leveraged SOEs would face difficulties in financing their investment or debt at low cost, deteriorating their financial situation and possibly leading to insolvency.
- **Political and bureaucratic resistance.** Financial repression has created economic rent which has been distributed to the favored borrowers and nurtured vested interests. Banks have enjoyed a comfortable business environment provided by high entry barriers, interest rate control, and excess demand for credit which allows credit rationing. Officials' power to control banks and their credit allocation is one source of their power over the economy and

[48] Data Source is from (Liu and Zhou, 2009). http://www.wcu-snuecon.co.kr/upload/catalogue_file/b828a8d86c926d2d14372f04dc2742f7.pdf

society. All these would work to mobilize resistance to financial reform and build a tendency of system inertia or regressing back to the old system.

Triggers for change

Internal and external forces that build up as their economies grow and expand eventually lead to financial liberalization and opening. This is illustrated by evidence from other countries such as South Korea and Japan (Annex 4). Such pressures will also mount for the Chinese authorities will also face mounting such pressures from both domestic and external sources in the course of transition from middle income to high income status. The following forces could intensify pressures for change in domestic financial system and drive the initiation of financial sector reform irrespective of the government's intentions over the next one or two decades:

- **Integration in the global market.** The Chinese financial system will have to become more integrated into the international financial system. China's rapid past economic growth owes, among other things, to the opening and integration of the Chinese economy into the global economy. This integration has so far been led by the trade and real sectors, and to a limited extent by the financial sector. In transition to a high income society, greater integration of the Chinese financial sector into the global capital market will be inevitable, as the business of Chinese firms would become increasingly globalized, and a growing number of foreign financial institutions penetrates the Chinese financial system.
- **Possible increase of NPLs and deterioration of banks' balance sheets.** If the current lending practices and governance structures of SOBs continue, they are likely to again accumulate large NPLs at some point in the future if the economic growth rate slows and the performance of SOEs deteriorates. The periodic increase in NPLs and repeated requirement to clean up bank balance sheets using taxpayer money could increase public discontent with the government's heavy regulation and control over the banking system.
- **Demand by the general public**. As income levels rise, and as households accumulate greater financial savings, Chinese citizens will demand a wider variety of financial savings options and asset investments. The demand for more equal and open access to economic opportunities will also increase. Likewise, as China's industrial structure and firms become more sophisticated and diverse, there will be a growing need for decentralized monitoring and governance of firms by market players. International experience indicates that financial services provided through securities markets become increasingly important for firms as economies mature, particularly with respect to high-technology industries.
- **Pressure from the real economy.** As noted above, to keep GDP growth at relatively high levels, China will have to rely more on the total factor productivity (TFP) growth through supporting innovations and efficiency improvements. More efficient capital allocation through the financial system will become increasingly crucial in sustaining growth.
- **External pressure from the global economy**. The implication of China's ascendance toward an advanced high-income economy for the global economy would be different from that of the ascendance of any other country in the past. Asian countries that took off earlier, including even Japan, could take the global economy and international economic system as an exogenous variable in the course of pursuing their development strategy. In contrast, the global economy and global economic system will no longer be an exogenous factor, but rather endogenous to the development of the Chinese economy. In other words, the interplay between China and the world will be a key factor affecting the nature and pace of the ascendance to WHC. This increase suggests that there could be tremendous potential for conflict and tension between China and the world economy in this process. China would play a major role in writing the rules of international trade and finance. It would be hard to imagine that such a country would maintain strong foreign exchange and capital controls with frequent interventions in the exchange market.

E. Sequencing of Reforms

Keeping adequate pace and sequencing would be very important for the successful progress of financial liberalization and opening. China's financial sector has served for the rapid economic growth reasonably well over the last three decades, and in the process, it has been reformed and restructured. However, in view of the current and expected future economic circumstances, it should be further reformed and restructured. China may not need to pursue the same structure (including the ownership structure) and practices of financial market as we see in most advanced economies these days. It is also true that the liberalization and opening process would not be easy and could face many challenges including instability or temporary deterioration of economic performance, especially when it is not managed carefully. While managing financial reforms is as much art as science, and country-specific circumstances figure heavily, certain broad principles can be put forth, drawing on the experience of other countries.

Reckless deregulations driven by the interests of the regulated should be avoided as has been seen through the experience of financial crisis of many other countries, including the US and Europe. Liberalization should be complemented by strengthening regulation and supervision. On the other hand, too much regulation would choke innovations and improvement in efficiency. Striking the right balance is not easy but is an essential consideration.

- **Financial reform is the result of a political economic progress which can limit what is feasible in the near-term and slow progress.** Certain market-based reforms cannot be deepened without accompanying measures. Premature reforms may also be a source of financial instability. The histories of both Japan and Korea indicate that partial deregulation of the financial system led to regulatory arbitrage that ultimately proved destabilizing. It will therefore be important to introduce deregulation across various sectors in the financial system in ways that do not lead to major regulatory arbitrage. Liberalization should be parallel between banks and NBFIs, so that a severe disintermediation or rapid expansion in some sectors does not take place, and become a cause for financial crisis later.
- **The pace of domestic liberalization must be expedited when external opening of the financial system is envisaged.** While mounting external pressures eventually forced financial market opening in Japan and Korea, it also led to a significant shift of domestic financing toward offshore transactions or severe financial instabilities or when there had not been concomitant progress in domestic financial liberalization. In this regard, further interest rate liberalization should be expedited according to the principle suggested above. While China may be more able to resist external pressure, it would still need to accommodate demands by the rest of world to grow and prosper together. By liberalizing the domestic system earlier rather than later, and in a systematic rather piecemeal fashion, China could achieve the benefits of financial development without suffering undue instability.
- **Financial market infrastructure should be strengthened prior to liberalization.** In order for the system to embark on a virtuous cycle, it will be critical for the government to strengthen such infrastructure as quickly as possible and gradually reduce its influence in the internal affairs of the financial institutions to focus on the roles that belong to the government, including regulation and supervision, securing credible accounting and audit practices, transparency in transactions, as well as creating and enforcing the right incentives and mechanisms.
- **Financial reform can progress successfully only when accompanied by institutional and organizational reforms**. Liberalizing market rules without changing old institutions can deepen distortions. Unless the government's organization changes, its *modus operandi* of intervention/involvement in the financial system may not significantly change. This gives the system strong inertia against real liberalization. Again, the Japanese and Korean experiences could be cases in point. In this respect, in China, the reform of governance and incentive structure for management and staff of SOF, and institutional reforms of the relevant government bodies seems to be one of the high priority agenda.

Chapter 6 Land Policies

A. A Key Factor: Land

Land constitutes a key factor in China's quest for more efficiency-driven economic growth and more balanced and equitable development. Over the past three decades, land along with investment has fuelled China's extraordinary levels of infrastructure development, urban expansion and industrial growth and has contributed to maintaining social stability. Through its important links to the fiscal and monetary spheres, it has critically impacted on macroeconomic stability. The state, especially local governments, has been skillful in using land, a key economic resource, to carry out its industrialization and urbanization strategies. Following the commercialization of finance, land has also become an important means to strengthen the links between government and business. Although China seemingly has some of the most rigid regulations for land use, land is often used by local governments to motivate investments, but often in a discretionary and distortionary fashion and to the detriment of rural land rights holders.

In the future, a sound land policy and legal framework and enforcement mechanisms will be prerequisites for continued development and structural changes. More efficient land use will promote TFP and GDP growth, help maintain employment, and ensure China's domestic food production capacity. Well functioning land markets will allow farms to grow into units that can raise rural incomes and promote efficient and livable cities. China's land policy will remain critical for maintaining social stability. In the context of rapid urbanization and migration, rural land will continue to serve as a social safety net in hard times. And land, in one form or another, will remain an important source of public revenue at local levels.

Over the last three decades, China has made impressive progress in reforming and developing its land-related policy and legal framework. From the introduction of the Household Responsibility System (HRS) in 1978 through to the Property Law of 2007 and the 2008 CPC '*Decision on Important Issues Concerning Rural Reform and Development*', a range of policy decisions and legal reforms have significantly addressed the questions of security of tenure and access to land, particularly agricultural land, and property. (See Box 12 for a summary of key milestones in rural land reform). In urban areas, a well functioning market for urban land use rights has been established and advanced since the mid 1980s and robust regulations on land takings and compensation are in place.

However, previous reforms have left in place a number of problematic policies, institutional arrangements, and implementation practices. Additional significant land-policy related challenges have emerged in the course of rural-to-urban migration and urban expansion.

To transit successfully to high income status and to realize a harmonious society, China will need to make some fundamental choices in land policy to overcome the constraints embedded in the current land tenure systems and to address the challenges that have emerged. Further reforms will have to reduce the complexity and contradictions inherent in the current system of collective and state ownership and emerging private property rights to land and ultimately treat the different types of land ownership and the associated private property rights equally within a clear legal, institutional, and policy framework. Such reforms will also have to set China on a path toward a more market-based allocation of land resources across the rural and urban spaces, ultimately in form of a unified land market. In parallel, the institutions to support such a market will have to be developed. Over this period, China will need to reconsider the State's unique monopoly power in the primary land market which gives it the sole right to convert land for urban use and allow for the role of the State to be transformed into that of a market regulator, administrator and service provider, and enforcer of rules. China will also need to ensure the equitable participation and sharing of benefits from land management and transactions among its citizens.

In the most general terms, in realizing its vision for 2030, China will have incorporated and adapted the critical benchmarks from experiences in high income countries to its specific economic, institutional and societal context. It will have in place a policy and legal framework that provides clarity on land ownership and property rights, allocate its land resources through open and integrated land markets that facilitate the accessibility and efficient allocation of land to various economic activities, operate institutions that are efficient, transparent, and accountable and support the functioning of land markets, and apply technologies and skills that support the efficient administration and governance of land resources.

BOX 12 Historical perspective: China's rural land-related policy reform and emergence of the legal framework

China's land policy and legal framework is evolving continuously in response to economic and social changes. Policy directions provide clear evidence of a consistent appreciation of tenure security. There is also a clear trend of embodying policies into laws towards of a comprehensive legal framework for land. The main reform milestones in form of policies and legal reforms over the past three decades included the following:

China's Constitution provides that land in rural and suburban areas, except for that stipulated as state owned, is owned by rural collectives. The Household Responsibility System of 1978 introduced the contracting of collective farmland to individual households for private farming, initially for a 5-year lease period that was later extended to 15 years (1984) and 30 years (1993). By 1983, virtually all arable land had been allocated to rural households. The HRS laid the foundation for strong agricultural and rural growth and for China's extraordinary performance in rural poverty reduction in the following decade (Lin, 1992; Ravallion and Chen, 2004).

The Party's No. 1 Document of 1984 laid down the foundation of China's current rural land rights system. It clarified the separation of collective ownership from individual land use rights and stipulated that collective land be contracted to households for a term of 15 years. It allowed for the voluntary transfer of individual land rights between farmers but did not provide guidance on land readjustments within the collective. The No. 11 Document of 1993 reinforced the HRS. It required that farmers' farmland rights be extended for another term of 30 years upon the expiration of the initial 15-year lease period. It endorsed transfers of farmland rights for value with prior consent from the collective and clarified the Central Government's view that administrative readjustments in response to population changes would violate famers' rights. The No. 16 Document of 1996 explicitly prohibited large readjustments and restricted small readjustments through the requirement of approval by two-thirds of the villager assembly or villager representatives and by township and county government. The document prohibited all forms of compulsory non-voluntary scale farming implemented through administrative order.

In 1986/88, the Land Administration Law (LAL), adopting the Hong Kong Leasehold System, legalized the granting use rights of state-owned land to private users and the transfer of such rights among them. In 1998, the revised LAL mandated that farmland be contracted to households for a term of 30 years. In the case of urban land, the LAL provided for marketable use rights of up to 70 years and created the legal foundation for an active urban land rights market. The LAL set out detailed procedures governing the taking of farmland by the State but did not include provision for the meaningful participation by farmers, such as prior notification, participation in determining compensation, and appeal during the expropriation process.

The No. 18 Document of 2001 provided further policy direction by prohibiting the compulsory taking-back of land rights by collectives and the re-contracting to non-villagers for value. In 2002, these policies were embodied into law by enacting the Rural Land Contracting Law (RLCL). It clarifies the relationship between collective land-ownership and farmers' land-use rights, the contents of land-use rights and governs the transfer of individual farmland rights. It provides that rural land contracting and operation rights held by farmer households "may be transferred (to other village households), leased (to non-village households), exchanged, assigned, or transacted by other means in accordance with law and provided legal remedies for any violations. The Property Law of 2007, the first comprehensive civil property code in modern Chinese history, articulates that all types of property in China—state, collective, and private—are entitled to the same level of legal protection. Furthermore, it characterizes farmers' rural land-use rights as property rights as opposed to the contractual rights defined by previous laws, and provides greater protection for small farmers' land right. It also reaffirms the provisions of the RLCL. Regardless of the type of land transaction, use rights transfers must adhere to the principles of voluntariness and free negotiation between transferor and transferee, compensation, freedom from compulsion, content and formal procedure, specification of contract terms, and a transferee requirement of possessing agricultural operational capacity. In 2008, the CPC's 'Decision on Important Issues Concerning Rural Reform and Development', introduced a landmark change to rural tenure in form of extending the 30-year term of famers' use rights for an indefinite period.

Land policy reform has been significant, but ensuring secure, marketable, and long-term land rights for all farmers remains challenging. A revision of the LAL is underway (as of 2011) and expected to further strengthen tenure security, clarify the scope of state expropriations for public interest, determine compensation approaches for land takings, and extend the protection of farmers' rights to all types of land, including residential and collective construction land.

This report outlines three land policy themes or issues that will be particularly critical for achieving high income status and social stability along with relevant reform needs and options: (i) tenure security in rural areas and governance; (ii) land policy and rural-urban integration; and (iii) land policy and municipal finance.

B. Tenure Security in Rural Areas and Governance

On its path to high-income status, China needs to improve overall tenure security in rural areas to create the right incentives for long-term investments and continued growth in agriculture and for rural to urban migration through: effective implementation of its policies of indefinite land use rights to farmland and strengthening the rights to other types of rural land; expanding land registration and strengthening rural land markets; and reforming and modernizing the governance structure of the rural collective.

Despite a relatively clear legal and policy framework on rural land tenure, rural households continue to have weak rights over land and often face expropriation risks. The resulting insecurity creates strong disincentives for longer-term investments in agriculture and reduces land consolidation and rental activities. For example, one survey finds that farmers that have at least one land document are 76% more likely to have made mid- to long-term investment than those who had not been issued a document (Landesa, 2010). Farmers with strictly law-compliant documents invested even more. Problematic aspects are found in persistent limitations in the tenure rights themselves, specifically with regard to the renewability and duration of existing farmland use rights and contracts that have not yet been embedded in the law. Equally important, the definition, protection, and the treatment of rights over rural residential and other collective land remain incomplete and problematic.

In addition, there remain serious difficulties in the implementation of policies and laws, in improving governance and accountability at the local level, in the documentation of land rights, and in citizens' low awareness of existing rights. Taken together, these create the potential for abuse of power and corruption. Disputes over rural land have become more frequent, for example, in cases were returning migrants want to resume farming and are claiming back their leased out land. About one quarter of villages across China is estimated to have been subjected to land consolidation and leasing arrangements to commercial enterprises; a recent and not yet well understood phenomenon.

This complex set of problems needs to be addressed in a carefully sequenced and integrated reform approach that strengthens tenure security in rural areas, likely involving the following elements:

Securing indefinite land use rights. Use rights to cultivated land need to be secured by expanding the renewability and duration of existing 30-year land use contracts and certificates. The CPC 2008 Policy Decision, with its stipulation of indefinite land use rights to agricultural land, was a landmark document in this regard. *Near-term* reform is expected to anchor the provision of indefinite household rights to farmland, as articulated in the policy, in the relevant laws. The reform towards indefinite land use rights will need to clarify who will be eligible for such rights, for example through determining farmers' land-rights-related membership in a collective.

In the *near- to medium-term*, supplemental reforms will have to tackle the currently poor quality of collective land ownership and individual use rights documentation. These could promote the introduction and implementation of a land certificate and contract system that not only specifies the property itself but includes core legal provisions and rights and responsibilities as well as sanctions in case of violations. Land contract and certificate documentation needs to be harmonized across the rural and urban spheres, for example, by following the standard format of China's existing urban land use rights certificate.

BOX 13 Legal and policy framework : international perspective

High income economies are typically characterized by widespread ownership of and access to land and property. Land is one of the most critical production inputs and accounts for a large share of national wealth in any given economy. Given the importance of land and property, high income economies have generally moved towards ensuring clarity of definition of rights and security of tenure of land and property. This has maximized its utility and potential contribution to economic growth, while minimizing negative impacts of state interference and lengthy, unproductive disputes. Thus, for example, while the ultimate level of ownership might lie with the state, it has long been established that the state retains in effect only minimal rights.

Constitutional and legal frameworks define basic ownership and how this may be given effect with regard to alienation, inheritance, divorce, mortgaging, etc. Registration and cadastral administrations define these rights and parcels from a recording perspective, covering an increasingly wide range of tenures and rights. Legal frameworks also define the bases for defining values (for example, in the contexts of compensation for compulsory acquisition/expropriation, taxation and accounting) and for defining processes for change of use (through planning, zoning and land use regulations). As a result, associated rights and responsibilities are generally considered secure and well defined, which facilitates economic activity. While uncertainties in tenure and transactions can never be entirely eliminated, these are somewhat predictable and can be offset by risk management strategies, including insurances of various kinds.

High income economies, reflecting in part the power of the vote and in part that of social groups and consumers, typically have well-developed legislated social policies and codes. Legislative provisions define basic landlord and tenant arrangements in both housing and commercial sectors. Similarly, legislated and regulated environmental policies defining restrictions and responsibilities have significant impacts on how land and property may be used and on its value. Increasingly, social and environmental safeguards are conforming to international standards and codes of practice, facilitated by international fora, conventions, and agreements.

Improving land registration. China and most other developing countries lack a reliable complete national inventory of land parcels. While the full establishment of a national land inventory may not be feasible in the short- or medium-term, effective implementation of land rights will require some degree of clarity about the location and extent of the land to which the rights apply. More reliable, precise and accessible records concerning the location of individual land parcels and who has what rights to a given parcel will help strengthen the trust and sense of security of contract owners, help reduce land disputes, and facilitate the more efficient implementation of land related laws.

The Government has recognized the role of land registration in promoting tenure security, rural growth, and rural-urban migration and has alredy piloted various land information management systems and methodologies. *Already in the near-term,* the registration of farmland needs to be scaled-up to realize its broader benefits. Significant start-up investments will be required to pursue the systematic and free initial registration of farmland. Ultimately, as international experiences show, land registration can be self-financing through fees for secondary transactions. Lessons from other countries indicate that administration of the land registry under a single agency could be one favorable option, as this arrangement avoids overlapping jurisdictions and parallel systems and approaches. Over time, land registration and the issuance of standardized rights certificates will gradually have to be extended to all types of rural land.

Developing Rural Land Markets. The transition to transparent and efficient markets for farmland use rights will be important to promote productivity and GDP growth and in addressing China's rural-urban income gap. Gains in productivity of land use via land rental in a growing economy, such as China, can amount to 60 percent (Jin and Deininger, 2009).

BOX 14 Land markets: international perspective

One key pillar of economic development in high income countries is the existence of efficiently functioning land markets. All economic activity requires access to land. Land markets facilitate accessibility, which allows land to be used in the most economic way, thus to increased economic activity and greater prosperity. Prerequisites for an efficient land market include clear land policies, an appropriate legal framework, secure land rights, capable institutional and professional services, transparency and availability of information, and easy access for all.

Land transactions are often complicated, due to the complexity of the property rights being transferred, the amount of money involved and the regulatory framework within which they take place. In the US and the UK, sales by private treaty (i.e. for a price agreed directly between seller and buyer) are by far the most common form. There is no single land market. In addition to the different use sectors, separate markets reflect the diversity of tradable property rights, including freehold (or "full" ownership), strata title, fractional title, timeshare, leasehold, and other property-related rights such as quotas, carbon rights, and transferable development rights.

Efficient land markets depend upon accessibility of information by buyers, sellers, professional advisers and other intermediaries. In developed countries, public sector land administration systems register transfers of ownership and transfer prices and make them available for public inspection. In addition, data on transactions is usually published through national statistics offices. With the recent growth in e-governance, the trend is towards improved web-based access and electronic public services in analysing and disseminating data on property transactions.

The functioning of markets for farmland serves as important benchmark of tenure security. During the 1980s and mid-1990s, less than 5 percent of cultivated farmland was being planted under rental tenancy (Li, 1999; Brandt *et. al.*, 2002). Since the mid-1990s, rental markets for cultivated land have developed in a more vibrant way. Despite little systematic official information, recent surveys provide some evidence of the expansion of the rural land rental market. The share of cultivated land that is being rented out was only 7 percent in 2000, but increased to 19 percent in 2008. More land is being rented out in coastal and in southern China than in inland areas or in northern China (CCAP, 2008). A DRC survey in 2007 covering almost 3,000 villages found that 21 percent of cultivated farmland has entered the rental market. In Anhui and Shandong land turnover ratios were 12.4 percent and 6.1 percent, respectively (World Bank, 2010b). Most of the present transfer activities are informal transactions and in the absence of enforceable contracts have led to inefficient and narrow market segmentations where sanctions can be enforced informally.

The transition to efficient markets for farmland rights over the coming decade will be complex and difficult. The development of appropriate market institutions will need to proceed in parallel with complementary reforms, including household registration reform, promotion of labor mobility and expansion and access to social security systems. In due course, tenure security to other types of collective land and their marketability will have to be strengthened in similar ways. In the *longer-term*, rural land use rights holders need to be given access to the urban land market and become full participants in the sharing of benefits whenever rural land is being converted to non-agricultural purposes.

BOX 15 Institutions: international perspective

To work efficiently, land markets must be supported by a wide range of institutions. In high income economies, institutional development has progressed alongside economic development as a means of dealing with the complexities of land administration, management and markets. The list of institutional stakeholders involved in well-developed land markets is immense, ranging from policy makers to brokers, mortgage lenders to lawyers, and valuers to registrars.

Government institutions provide the policies, laws and regulations governing all aspects of land use. Their interaction is often complex, with functions divided between ministerial departments and different levels of government. These functions include land use planning and enforcement, the implementation of property taxation, management of state-owned land and land registration. Recent years have seen a trend towards commercialization, with government institutions operating as 'agencies', outsourcing service provision to the private sector, and entering public-private partnerships. These innovations have been driven by the demand to cut costs, improve accountability, increase accessibility, and enhance capacity. Examples in the UK include the Valuation Office Agency which is responsible for valuing properties for taxation purposes and the extensive use of private sector firms by the Ordnance Survey, the national mapping agency.

Enforcement of laws and regulations is primarily a state function. Each country has its own unique and hierarchical court system. In many developed countries, these institutions are supplemented by special courts and tribunals which deal with specific areas such as land acquisition, taxation, accounting, etc. For example, in England and Wales, the Lands Tribunal determines disputes as to compensation payable to owners and occupiers of land affected by expropriation, while independent Valuation Tribunals, have jurisdiction over annual property tax appeals by taxpayers. In addition, many countries have developed non-court dispute resolution systems. These are usually administered by recognized independent professional bodies, such as the Royal Institution of Chartered Surveyors (RICS) in the UK.

Competent, reliable and accessible professional services provide an essential link between buyers and sellers and government institutions active in land markets. In addition to bankers and financial service providers, these include, lawyers and conveyancers, brokers or estate agents, valuers, land surveyors and structural surveyors, accountants, and others.

Reforming the institution of the collective. The relatively low degree of land tenure security is part of a larger grass-roots governance deficit. The unresolved opportunities for abuse of power and rent seeking of village cadres at the expense of the members of the collective, for example in practices of land readjustment or commercial development, and the relative absence of transparent and accountable governance structures at the rural collective level, point to larger problems in the relationship between the collective entity and individual land use rights holders. Although recent surveys point to a reduction in the frequency of such reallocations, on average every village surveyed experienced at least one partial reallocation during the period 1998–2008 (Wang *et al.*, 2010).

A key policy challenge in rural areas of China for coming two decades is how to modernize the institution of the rural collective to remain relevant and consistent with the evolving shifts in law and policy, specifically the transition from the original land use rights contracted for a specified term under collective administration towards indefinite, inheritable, and transferable individual property rights to land. Reform will need to clearly define the nature of collective ownership and unambiguously identify the members of the collective, and clarify the relationship between collective ownership of land and individual rights to land in view of the Government's push of a transition towards stronger and indefinite individual property rights. Such reform will require not only the strengthening of governance at the collective level but involve a fundamental redefinition of the remaining functions and roles of the collective entity as its responsibility for land management may no longer be relevant.

C. Land Policy and Rural-Urban Integration

On its path to high-income status, China needs to introduce fair and transparent rural land acquisition policies and practices, curtailing the role of the State in land requisition, and ensure more socially compatible rural-urban integration through allowing collectives and land use rights holders to share the benefits from urbanization.

The Government promotes urbanization and rural-urban integration as part of China's overall development strategy. But China's land tenure system remains urban-development biased at a time where the rural-urban income gap has widened to levels rarely observed in other countries. It also remains characterized by the strict separation and different treatment of rural and urban land. Within this separation, the State's exclusive power to acquire rural land and transfer it to urban users favors the currently uncontrolled and often inefficient pattern of urban development. The resulting land acquisition practices seriously disadvantage both the collective and the rural land use right holder in sharing in the appreciating value of land entering the urban market.

These features are historically determined and were justified in the early years of China's development when agricultural surpluses supported the initial stages of industrialization. But these features, which are highly unusual by comparison to high-income economies, are now less advantageous to China's development and a major obstacle to a harmonious rural-urban integration. The widening rural-urban income gap, widespread land-related social conflicts caused by this separation, and other serious problems put this feature of the present land tenure framework and policy into question.

The persistent duality of rural and urban land systems needs to be managed and ultimately phased out. Rural-urban integration efforts have been promoted in form of various pilot efforts at the local level throughout China with a view to develop a more comprehensive policy reform framework in the future. Many of the pilots have brought new challenges to the surface and often have created their own problems.

Two fundamental policy reform need to be pursed towards a more harmonious integration of rural and urban areas and citizens: the reform of China's current rural land requisition policies and practices as a pressing *short- to medium term* issue; and the integration of rural and urban land markets for more equitable benefit-sharing in the longer term.

Reforming land requisition and compensation practices. Across the world, governments have the power to acquire land on a compulsory basis in certain circumstances and subject to conditions. In China, the scope of this power is unusually wide by international standards and its use has been very extensive. During 2003–2008, a total of 1.4 million hectares of agricultural land, of which about 950,000 hectares were cultivated land, are estimated to have been requisitioned under current laws, while an additional 450,000 hectares are reported to have been requisitioned illegally during the same period. The impacts of compulsory land requisition have not been isolated and relatively localized as they might be in other countries. The process of land requisition needs serious reform in three dimensions.

First, Chinese law does not explicitly limit the purposes for which the State can use its power of compulsory acquisition. In contrast, no high income country allows its government to use compulsory acquisition as the normal means of assembling land for purposes that are clearly commercial or industrial in nature. In the *near-term,* to be more in line with international practices, tighter constraints on the use of State's power for land requisition will need to be clarified in the legal framework and implemented along the overarching principle that government's taking powers are extraordinary powers that should be limited to meet public needs that are not well-addressed through the operation of the market. Such reform needs to go hand-in-hand with allowing the emergence of market mechanisms that span the urban-rural divide.

BOX 16 Rural/urban integration and linking mechanisms: current and emerging issues

In contrast to farmland use rights, Chinese laws do not extend the same level of protection for farmers' residential land or other collective land, such as collective construction land. In 1962, when China's agriculture was still collectivized, residential land was allocated to farmer households to use 'for a long time without change' creating a de facto individual property right to residential land. The limited legal protection of rural residential land is cause for major disadvantages for farmers in the land conversion process. The legal vacuum has allowed many opportunities for experimentation and policy pilots that can infringe on farmers rights and contradict and circumvent Chinese laws.

Local governments throughout the country are pursuing a range of programs aimed at promoting urban-rural integration. These programs often target farmers' rights to farmland and residential land through an approach of 'exchanging farmland rights for social security coverage and exchanging residential land rights and houses for urban apartments'.

Initially put forward in 2004, these so-called linking mechanisms involve the reclamation of rural (collective) construction land, including farmers' residential land into farmland. Every unit of land reclaimed corresponds to a reduction of one unit of rural construction land, and to an increase of one unit of farmland within a given jurisdiction (discount factors apply to account for differentials in land quality). This unit of reclaimed farmland creates one unit of construction land quota that can be applied elsewhere in the jurisdiction. At this 'somewhere else' place, usually the peri-urban areas where the urban land market price is high, the government can convert one unit of farmland to non-agricultural use and grant use rights to this new non-agricultural land to developers.

Through this mechanism, currently non-transferable rural residential land rights can be made marketable. However, the legally and institutionally poorly protected collective construction land as well as household residential land use rights have become a major target of local government for expropriation and revenue generation and for developers for urban construction. Also, while such 'exchange' of farmland rights is often classified by local governments as voluntary land rights transfers, it can in fact constitute illegal appropriation of land rights.

More importantly, forcing farmers to give up their property rights to land in exchange for social security coverage also poses a moral dilemma. While urban residents do not need to give up property rights in exchange for social security coverage, rural residents must undertake such an exchange. This practice also contradicts the intention of the Property Rights Law (2007), which requires that all type of property rights enjoy the same level of legal protection.

Second, current practices of compensation for requisitioned land need to be reviewed as they are a frequent cause of complaints about unfairness in the land requisition process. These are based on agricultural output value but do not consider the value of the land in its eventual urban use. The standard for compensation of cultivated land is a multiple (generally the duration of the land use contract, i.e. 30 years) of the average annual agricultural output over 3 years. This practice is problematic in a context where the differential between urban and rural incomes and livelihoods is so large, and where this differential is reinforced by the separation of rural and urban land markets. A rethinking of the compensation practices, particularly where land is requisitioned for commercial purposes, is needed. It is recommended to consider international practices where compensation is usually based on the market value in the best possible use.

Third, shortcomings in the land requisition process itself need to be addressed. While the laws set out the procedures for the taking of agricultural land by the State and require local government to make public and receive comments on the resettlement plan, such practice often takes place only after the requisition has been approved. In addition, there is no explicit requirement that collectives or farmers be advised of the requisition ahead of time and be given an opportunity to react. Already in the *near-term*, reforms of the requisition process need to introduce key provisions such as advance notice, provide the opportunity consultation and participation during the requisition process itself as well as put in place workable channels for appeal and dispute resolution.

Integrating land markets for equitable benefit sharing. China's long-term land policy vision needs to consider more broadly how to rebalance the relationship between the State's monopoly in the primary land market and the collective and farmer participation in the conversion of agricultural land. Measures to decrease the urban-rural gap will have to consider fairer benefit-sharing approaches through, for example, gradually granting access for collectives or rural land use rights holders to participate in the transfer of rural land to the urban land market, while at the same time, reducing and ultimately phasing out the State's monopolist power in the primary land market.

Experiences for successful rural-urban transitions and integration process exist, for example in Taiwan (China) and South Korea. Both economies were able to make farmers' land rights secure and free from administrative intervention. This enabled farmers to invest in land, resulting in much increased land productivity and deriving sufficient revenues for their urban endeavors. Urbanization took place in a small farming setting with low per capita landholdings. Both economies adopted a farmer-friendly approach to the conversion of farmland for non-agricultural use and introduced comprehensive measures that let farmers capture a share of the increased land value as a result of conversion.[49] In both economies, farmers were automatically covered under urban social benefits once becoming an urban employee. In China, land requisition and urban expansion have not only limited farmers' proceeds from their land assets but also to led to an erosion of rural land rights itself in form of excluding collectives and farmers from the urban land market. A comprehensive reform program to better safeguard rural land ownership and, even more importantly, individual land use rights for farmland and residential land, in the process of urban-rural integration process needs to be put forward.

Across China, several reform pilots are currently underway, most prominently in Chongqing and Chengdu. These pilots are experimenting with rural-urban integration approaches and promote the registration and definition of rural land ownership and property rights, the development of policies and mechanisms for the transfer and marketing of rural construction land for urban development, policies for the protection of farmland, labor mobility and social protection reforms, as well as other elements. While the lessons and experiences of these pilots are to be collected and carefully evaluated over the coming years, the broader reform directions for making the rural-urban integration process more equitable are suggested to include the following:

[49] For example, Taiwan (China) adopted a law which introduced "zone expropriation" for the provision of land for urban development projects, especially those of a commercial nature. Under such processes, a farmer landowner may demand 40–50% of the expropriated land as compensation in lieu of cash, and thus share partially but significantly in the gains from such development.

BOX 17 Land policies to promote rural-urban integration in South Korea

Tenant farming predominated in South Korea before World War II. After WWII, a massive land reform was conducted to distribute to former tenants the land purchased from Korean landlords or confiscated from the Japanese. As a result, more than 1.5 million farmer households received land, and the farm ownership rate was raised from 13% to 71%.

South Korea took a series of legal and policy measures to prevent scale farming aimed at avoiding social disruption in the course of urbanization. During most of its period of urbanization, tenant farming was prohibited. This ban was slightly lifted in 1986 when the farming population dropped to less than 35% of the total population. The average farm size rose from 0.9 ha in 1970 to just over 1.3 ha in 1995. South Korea also prohibited corporate ownership of farmland and corporate farming. Such prohibition was lifted only in 1990, with two restrictions remaining in place. First, half of the total investment by the corporation must come from farmers or farmer families. Second, the representative of the corporation as well as more than half of the executive board must be farmers.

One of the important mechanisms adopted in South Korea's urbanization process was its land readjustment program launched in 1966. Upon the designation of the project site agreed by 80% of owners of affected land, about 40% of the assembled land will be used by government to develop infrastructure and finance such development. The remaining 60% of the developed land is then distributed to participating landowners in proportion to their land contribution to the project. These landowners may choose to sell their value-added land or use it for other commercial uses. More than 50% of built-up areas in Seoul and over 40% in Pusan were developed through such land readjustment projects.

Curtailing the State's land requisition and opening the market for construction land. As noted above, the State's power and scope for compulsory aquisition needs to be restricted to a more narrowly defined 'public interest'. This will need to go hand with the gradual introduction of a unified market for construction land. In such a market, collectives and individual land rights holders would participate on an equal basis with the State in the conversion and trading of collective construction land in the primary land market without prior conversion to state ownership. Over the longer-term and within a framework of approved and enforceable urban development and land use plans, collectives and individual land use rights holders could also be empowered to participate in the conversion of collective farmland to non-agricultural purposes and be allowed to sell and buy land use rights across the rural-urban divide and benefit from it.

The capital gain accruing to collectives or individual land use rights holders could be subjected to a tax to be set at a rate that accounts for the 'public good' element of the land conversion to urban uses. Alternatively, the zone expropriation model practiced in Taiwan (China) or South Korea's experiences with rural urban integration may offer valuable lessons on how to rationalize urban and industrial planning with fair participation and benefit sharing of the rural population in the development process.

Addressing the urban village problem. Reform towards a unified market for construction land needs to be carefully sequenced. One option would be to begin in urban areas where collective land ownership is still widespread in the form of 'urban villages'; collectively owned land, generally construction land, that was not requisitioned by the State when cities were expanded through the requisition of collective farmland. Because of the much higher compensation cost for collective construction land as compared to agricultural land, collective construction land remains scattered throughout many urban areas in China. The persistence of urban villages is one cause for inefficient city development and urban sprawls. Allowing collectives in urban areas to trade their collective construction land in the primary urban land would likely lead to more efficient development and to higher density land use in urban areas.

Strengthening checks and balances in urban development planning. The transition towards a unified urban land market will require a strict and enforceable implementation of urban and industrial land use planning. While China has in place a relatively rigorous urban planning process, implementation and enforcement of long-term master plans is weak. In addition, there is no system to take into consideration the long-term interests of urban residents and to hold decision makers responsible for the social and environmental consequences of urban development decisions. The weakness in checks and balances in the current urban planning system may be overcome through opening the planning process for public participation and scrutiny and transparency through mass media.

D. Land Policy and Municipal Finance Reform

On its path to high-income status, China needs to address the distortions in its local governance and finance system and reduce its excessive reliance on land transfer-based revenue generation through the introduction of property taxes and reform of land requisition practices.

China's land policy and municipal governance and finance systems are closely interrelated and both are shaping the country's urban land use and form for generations to come. Both the spectacular achievements as well as the enormous challenges in the area of urban planning and development grow out of the country's decentralized governance structure and fiscal systems.

In 1994, China adopted a tax sharing system that provides separate tax-collection powers for the central and sub-national governments. This system has left many municipalities with a mismatch between local revenue and responsibilities for public service provision. In this setting, the combination of the State's power to expropriate rural land and its monopoly in the urban land market, and incentives created by a highly GDP growth-focused system for evaluating local officials, has encouraged local governments to generate additional income from land transfer fees.

Local governments have also become increasingly reliant on mortgage loans using requisitioned land as collateral through the vehicle of land banks. The practice of land banking by public entities created under local governments has grown phenomenally in recent years. Land banks can mortgage the land they hold to state banks and invest the loaned funds in urban development. The aggressive requisitioning of rural land to generate local revenue is risky and is contributing to unsound forms of urban growth, unsustainable local finance and inefficient use of land resources.

Introducing market value-based property taxes. While income from land transfer fees has become a significant source of local public revenue, real property in China is subject to a range of minor fees, taxes and charges, but there are virtually no annual taxes on property. Over time, property taxes could provide a sustainable substitute as receipts from land trading are reduced in parallel with a reform of land requisition practices. Property taxes are often one of the few major good sources of own revenues for local governments, and could in principle allow the cancellation of a range of difficult to collect 'nuisance taxes' which can be harmful to the local business climate.

However, the property tax will take time to grow into a significant revenue source. Even in the long run, it is unlikely to fully replace income currently generated by sale of land use rights. Bahl (2009) notes that only a few countries like the US and Canada raise on the order of 3 to 4% of GDP from such a tax, with the OECD average being 2.1% of GDP. Among developing countries, the average collection is only 0.6% of GDP, with only a few countries (such as Uruguay) raising as much as 1.0% of GDP. As the introduction of a property tax is institutionally complicated, and as difficulties in establishing initial valuation would also argue for setting initial rates at relatively low levels, the initial take from such taxes would probably fall well below such averages. For this reason, local governments will also have to reduce their dependence on revenues from land use rights in a gradual fashion.

Implementation of a property tax is a complex task, and even in well-established systems, significant reforms are often required. International experience provides guidance on the necessary preconditions for effective implementation, such as the existence of adequate technical expertise for property assessments as well as the administration of appropriate land records. The development of such institutional capacity could already begin in the *near-term*. Political understanding and will are critical preconditions if the substantial challenges of implementing a highly visible and difficult to evade tax are to be overcome. The introduction of property taxes should be coupled with a simplification of the overly complex current system of property based fees and taxes to ensure that any such taxes fulfill their particular purpose and do not have an adverse effect on the real estate market.

BOX 18 Land valuation and taxation: international perspective

Most modern land administration systems include a significant valuation and taxation function. Public sector valuations are required for a variety of purposes, including property taxation; purchase, disposal and renting of state land; and assessment of fair compensation where land is acquired through expropriation. An efficient land market, including the easy access to reliable market data, provides the platform for transparent and accurate market-based valuations. High income economies have well-developed public and private sector valuation professions using internationally recognized methodology and standards. Valuers increasingly benefit from advances in IT-based automated valuation models, which particularly lend themselves to the mass-appraisals required in country-wide land tax assessments.

Most developed countries impose property taxes—usually transfer tax, estate duty, and annual property tax—based upon actual sale prices or assessed market values. Market value is generally considered to be a fair and equitable basis of taxation. In the US and Europe, taxes on land and property provide a cornerstone of municipal finance. They have the advantage of being widely accepted by the tax-payer and are sustainable, predictable, and tend to provide a hedge against inflation over time, thus ensuring revenue maintenance in real terms. Over the past two decades, developments in IT have made electronic billing and payment a central feature in both local and central government financial management.

Effectively regulating land banking. China needs to review the extent to which land banking has moved away from what was arguably its original purpose, namely to serve as a planning tool devoted to the timed and targeted release of surplus government land in support of overall planning objectives, towards becoming an undesired conduit for requisitioned lands that are slated for disposal through auction, devoted to profit maximization and to securing land-backed loans. There is no national law or national regulation on land banking, though the practice is referred to permissively in some government documents. More effective regulation is urgently needed as land banking practices may be of a sufficient scale across the country to have serious implications for the economy generally, and particularly, in the financial sector.

Annex 1: Why Did China Grow So Fast?

A wide range of factors contributed to China's rapid growth. These can be viewed from three different perspectives: (i) "growth accounting"; (ii) a review of exogenous factors which favored growth; and (iii) a discussion of the role of domestic policies and physical investments.[50]

First, China's growth performance reflected strong contributions from labor and capital accumulation as well as total factor productivity (TFP) growth. Favorable demographics, especially during the early reform period, generated a large "dividend" in the form of a labor force growing faster than the overall population. Second, very high and rising investment rates, supported by even higher and more rapidly rising savings rates, allowed rapid capital accumulation. Over time, a gradual decline in the labor contribution was broadly compensated by the effect of a rising investment rate. Third, by World Bank staff estimates, TFP growth (including the contribution from improvements in human capital and factor reallocation) remained in the range of 3–4% per year, which is exceptionally high by world standards.[51]

Second, China's rapid growth was supported by three broad sets of exogenous factors. These were:

The potential "advantages of backwardness". Under the "opening up policy", China was able to borrow technology and social and economic institutions from the more advanced countries, and thereby innovate and upgrade its industry at low cost and risk (Lin, 2010). Lee and Hong (2010) find evidence that such forces were at work.

A high initial level of distortions. The Chinese economy of 1978 was heavily distorted by previous policies which played to the country's comparative disadvantages. To achieve its aim of developing large, heavy and advanced industries, the government was forced to protect such activities through various distortions, including suppressed interest rates, low input prices and an overvalued exchange rate (Lin, 2010). This left a sectoral and spatial misallocation of resources, as well as a closed economy with limited links to the rest of the world. While negative in their own right, such distortions also create greater scope for increases in TFP through policies aimed at their removal.

A supportive external setting. The global environment for much of this period (Vincelette, *et. al.,* 2011) and the structural shift to more globalized forms of industrial production (Yusuf and Nabeshima, 2010) both worked in China's favor as it pursued a strategy of opening to the rest of the world. This process included China's accession to the WTO in 2001 and associated changes in tariffs and other policies, as well as a gradual opening to foreign investment.

Third, and most importantly, China was able to exploit these favorable conditions to generate rapid growth by implementing a stream of pragmatic, market-oriented reforms, and by deepening domestic market integration through improvements in infrastructure and logistics. Landmark reforms include the introduction of the household responsibility system in agriculture, the opening up of the tradables sector beginning with the establishment of special economic zones, extensive price liberalization, deep reform of the fiscal system, restructuring and privatization of SOEs, and reforms associated with WTO accession. Other important contributors included improved macroeconomic management, factors supporting a high saving rate (the combined effect of rapid productivity gains, contained wage costs, and a managed exchange rate on enterprise profitability, and of buoyant revenue growth and contained current spending on government savings), and strong subnational government-led inter-regional competition to attract investment. Improved policies and the sustained reallocation of factors to higher productivity uses helped keep the marginal product of capital high despite a high and rising investment rate (Bai, Hsieh and Qian (2006); Song, Storesletten and Zilibotti (2009)).

---

[50] For more discussion of factors behind past performance, see Hofman and Wu (2009), Huang (2011), and Vincelette, Manoel, Hansson and Kuijs (2011).

[51] Kuijs (2010) finds TFP growth of 3–3.5% per year from 1978–2009, of which about 0.5% comes from enhanced human capital. Bulman and Kraay (2011) find TFP growth of 3–4.1% per year from 1979–2008, over one-half of which they attribute to factor reallocation.

Annex 2: China's Industrial Policies: Key Actors and Defining Characteristics

Such interventions are currently *implemented* by three broad classes of actors: (i) high level national bodies; (ii) central government departments; and (iii) sub-national (provincial and local) governments and their departments. In turn, they are *influenced* by other stakeholders, such as industrial associations and firms themselves.[52]

The main high level bodies include the State Council, the National Peoples' Congress (NPC) and the Communist Party of China (CPC). The State Council can issue comprehensive multi-sector documents or policy guidance for a single sector, with the aim of promoting a particular structure across or within industries.[53] Laws enacted by the NPC can include elements of industrial policy with significant impacts on certain industries. Finally, "work reports" to various National Congresses of the CPC have included important strategic guidance (e.g. on the selection of "pillar industries") which laid the ground for follow up implementation measures.

Several central government departments release related policies in accordance with their responsibilities. These include the National Development and Reform Commission (NDRC), the Ministry of Industry and Information Technology (MIIT), and others. For example, the "Guiding Catalogue of Industrial Structure Adjustment" and "Catalogue of Industries for Guiding Foreign Investment" periodically issued by NDRC are comprehensive policies, identifying industries to be "encouraged", "restricted" or "prohibited". NDRC also issues industrial policy guidance for specific sectors. For its part, MIIT has formulated "Opinions on Promoting the Merger and Reorganization of Enterprises", which was released by the State Council in 2010. The role of sub-national authorities and their departments is discussed in the main report.

At present, China's industrial policies have seven defining characteristics:

1. They are scale-oriented, i.e. focused on the development of larger enterprises. For example, in 1993, the central government announced a strategic restructuring of SOEs, including through establishment of large scale enterprise groups. In 1997, the 15th National Congress of the CPC declared the "Restructuring Major Enterprises and Relaxing Control over Smaller Ones" strategy to develop large scale enterprise groups. Since 2000, "fulfilling large enterprise group strategy in key industries" became a central element of China's industrial policy. Specific instruments include: formulating a scale-oriented industrial development plan; establishing examination and approval conditions which limit entry while favoring large incumbents, etc. (Jiang and Li, 2010).

2. They have sought to control the expansion of sectors deemed to have excess capacity. As early as the 1980s, when the basic thrust of policies was the promotion of industrial expansion, some sectors were already identified as having excess capacity, including textiles, automobiles, and home appliances. In the 21st century, curbing the development of industries with excess capacity became a central pillar of China's industrial policy, especially in periods of macro adjustment. Since 2007, sectors targeted by the State Council as "controlled industries" included iron and steel, textiles, alumina, coal chemicals, flat glass, caustic soda, cement, solar polysilicon, shipbuilding, chemicals, solar, and wind power. In such sectors, new entry could be restricted, capacity expansion projects might not be approved, companies could face

[52] In the past, the NDRC (or its predecessor, the National Planning Commission) led the design and implementation of industrial policies, while specialized departments took charge of detailed work and local governments and other stakeholders participated in the process. With reform, most of the specialized economic departments have been abolished, while other stakeholders have become more powerful.

[53] An example comprehensive document is the 2010 State Council Decision on the development of "Strategic Emerging Industries", which identified seven priority industries. An example single sector document is the 2005 "Development Policy of the Iron and Steel Industry".

prohibitions on financing through corporate debt and IPOs, and outdated production capacity could be targeted for elimination.

3. They have aimed to concentrate sectors deemed to be too fragmented. During the 11th 5YP period, the government vigorously encouraged stronger enterprises to acquire weaker firms, as well as other measures to encourage concentration. Subsequently, documents from the "restructuring and revitalization plans of ten industries" to the 12th 5YP have all noted the need for "enhancing industrial concentration." Some provincial governments have in turn used such resolutions as a policy foundation to promote a similar concentration of their own sectors. For example, Hebei and Shandong provinces promoted the merger and integration of their iron and steel industries in 2008–09, while Shanxi and Henan province pursued such aims in their coal sectors in 2009–10.

4. Policies to encourage technological advancement have had industrial policy dimensions. Such policies have included requirements to use specific local technologies, e.g. for one large mobile telecommunications operator to use the indigenous TD-SCDMA 3G technology. Some such technologies have scale economies which preclude their use by smaller producers. This again tilts the playing field towards larger firms.

5. **They have relied heavily on direct administrative intervention to introduce (withdraw) resources from preferential (prohibited) sectors.** While market mechanisms also play a role, the authorities often use very direct means to "close down, suspend operation, merge and shift". These have included measures on market access, project examination and approval, land supply approval, loan approval, industrial guidance catalogue, compulsory elimination of outdated production capacity, etc.

6. They have often featured multi-division joint action. For example, the September 2009 "opinions on inhibiting excess capacity and redundant construction on some industries to guide the healthy development of industry" was jointly promulgated by 10 central ministries and commissions. It required joint action by departments for industrial management, quality management, investment management, environmental protection, land management, finance management, and local governments.

7. They have been pursued at each level of government, often at cross purposes. For example, while the central government may aim to consolidate a sector nationally, each province may seek to make this sector a "pillar industry" for its own economy. With over 30 provinces and many more sub-provincial authorities involved, the degree to which a particular sector is ultimately favored or discouraged becomes hard to discern.

Annex 3: Experiences of Japan and Korea in Financial Liberalization

In both Japan and Korea, financial liberalization was initiated by internal and external pressures. But the authorities had not been proactive, but rather reactive to developments. Institutional and governance reforms in banks, firms and regulatory bodies were very slow or even absent, leaving fertile soil for moral hazard while interest rate deregulation and capital market opening was in progress. In the process, regulatory arbitrage and risk were increasing. This ultimately led to financial crisis which had to be dealt with at huge public cost.

In Japan, three main internal and external forces led to financial liberalization. First, as the period of high economic growth reached an end in 1974, the corporate sector's investment demand slowed and firms started to accumulate surplus funds. The household sector had also accumulated substantial financial assets (deposits) by this time and started to seek assets with higher returns than bank deposits. On the other hand, government budget deficits which expanded as economic growth slowed, had to be financed by issuing larger volumes of government bonds. This led to the initiation of interest rate liberalization on government bonds and CDs as holders of those instruments required market-based interest, which had to expand to other interest rates to reduce the regulatory arbitrage.

Second, the internationalization of Japanese firms' operations required the domestic financial system to support the expansion of their international business, including the hedging of risk exposure and meeting financing requirements in foreign currencies. This spurred the relaxation of the foreign exchange system and increased entry by Japanese financial institutions into international financial centers by establishing branches and subsidiaries. Once Japanese firms were able to issue debt abroad, and Japanese financial institutions could make investments in foreign assets more freely, Japanese households' savings started to find their way to the purchase of (Euroyen) bonds issued (at uncontrolled interest rates) abroad by Japanese companies through Japanese banks and insurance companies located abroad. This process built up further pressure to liberalize the domestic financial system to reduce the potential for regulatory arbitrage and stem the flow of domestic finance to the offshore market.

Third, as the Japanese economy and financial market expanded, there was growing interest by foreign banks and NBFIs to penetrate the Japanese financial market who lobbied their governments to put pressure on Japanese officials. The continuation of Japan's large current account surplus dating from mid-1970s also increased foreign pressure, especially from the US, for the opening of the Japanese service sectors and capital markets, a pressure that was eventually accommodated. This put further pressure on the government to liberalize the domestic financial system as, otherwise, the distortion and weakness in the domestic system would have intensified.

In Korea, the government's control over the financial system was more direct and pervasive than in Japan. As in China, all banks were owned by the state and their lending activities were strongly controlled by the government through explicit policy lending programs and implicit window guidance. Interest rates were controlled and set substantially below the supposed market clearing rate. Government intervention grew stronger in the 1970s when the Korean government initiated a strong drive for heavy and chemical industry (HCI) development. This led to substantial overcapacity in the HCI sector and a large amount of NPLs in the banking sector, while light industries and SMEs were starved for credit. This in turn caused the deterioration of Korea's export competitiveness and slowed down economic growth by the end of 1970s, which culminated in the assassination of President Park. Partly as a response to this negative experience with heavy financial repression, and as part of its overall economic liberalization efforts, the Korean government began gradual liberalization of the banking system by privatizing banks and relaxing entry barriers for NBFIs.

However, true progress in banking sector liberalization was limited as the government still wanted to use the banking sector as a tool for industrial policies, and also because highly leveraged large corporations needed cheap and stable finance from the banking system for their survival. By this time, the large corporate firms (*chaebols*) had emerged as a strong vested interest group, with substantial influence over government economic policies. The government instead introduced greater market forces in the financial system by allowing the expansion of NBFIs, by relaxing entry of privately owned (including foreign) NBFIs such as finance companies, merchant banking firms, and insurance companies which were free from policy loan programs but could offer savings accounts similar to to bank deposits. As in the Japanese case, this liberalization was also caused by increasing external pressure, especially from the US, as Korean financial markets grew larger and as a substantial current account surplus emerged in the second half of 1980s. These developments reduced banks' shares of total deposits and squeezed their profits by shifting deposits to NBFIs. This in turn pressured the government to allow banks to expand into products offered by NBFIs such as trust account business.

The government started interest rate liberalization in the late 1980s but there was little progress until the early 1990s when it announced an interest rate liberalization plan. The interest rates on short-term money market instruments such as commercial paper and CDs were liberalized while maintaining control on bank interest rates. This accelerated the shift of funds to finance companies, other NBFIs and the trust accounts of banks. The net effect was a reduction of average maturities in the liability side of corporate sector balance sheets, which increasingly had to rely on these short-term financing instruments. Foreign exchange controls were relaxed due to pressures from both domestic firms, whose business had become more globalized, and foreign governments, which were pressured by their financial institutions to penetrate uncompetitive but expanding Korean financial markets. On the other hand, large chaebols and banks had built the perception that the government would not be able to let chaebols fail due to their huge impact on overall economic performance. In fact, the Korean government had protected the chaebols and financial institutions (including small ones) from failures and there had been no significant bankruptcies of chaebols or financial institutions before 1997. The combination of these led to two significant developments: increased reliance on short-term corporate finance; and increased foreign debt, especially short-term debt by financial institutions. In the first half of the 1990s, increased foreign capital inflows and domestic savings were channeled to large firms which expanded their investment recklessly, due in part to pervasive moral hazard that came with the perception of "too big to fail." The first factor caused a domestic financial crisis when overly leveraged large corporate firms could not service their debt and were faced with an economic recession starting 1996. Together with the first, the second factor caused a currency crisis when foreign capital flowed out massively from Asian countries in 1997, which intensified the domestic financial and economic crisis.

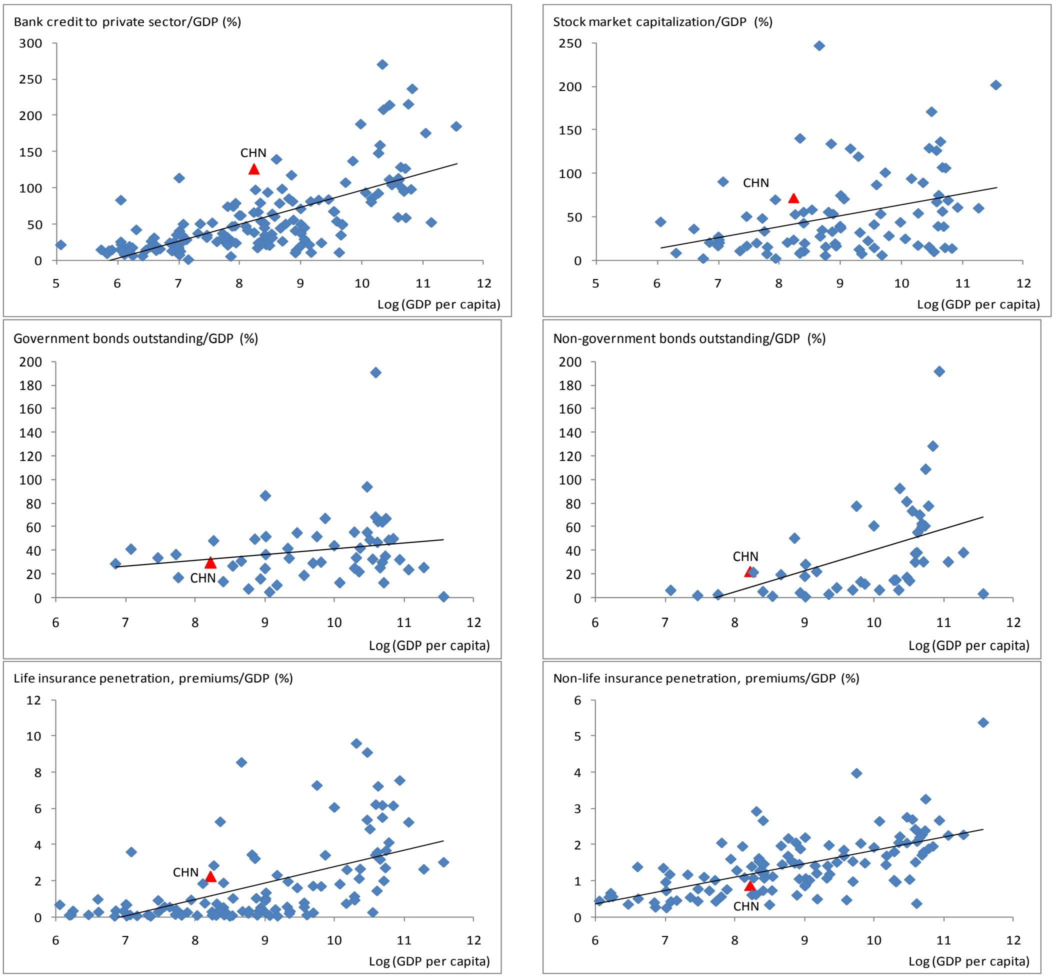
Korea completed full liberalization and opening of the financial system under its post-crisis IMF program, and massive financial and corporate restructuring with huge injections of public funds (equivalent to 1/3 of GDP) to clean up the balance sheets of financial institutions. Government control over finance was an effective vehicle for rapid industrialization and economic growth in the early stage of Korea's economic advancement, but it led to pervasive moral hazard in both the banking and corporate sector which again led to reckless investment by favored firms and poor risk management of banks. In the end, this required huge public costs to remedy the problems. Japan experienced domestic financial crisis as the asset bubbles, which was built during the second half of the 1980s with the moral hazard of financial institutions and poorly managed financial regulation, started to bust since 1991. It completed the financial liberalization and restructuring of regulatory framework/government organization by 1998, and financial restructuring by 2004. In the course, it experienced a prolonged and deep financial crisis which has to be dealt with through injection of public funds with huge public cost.

Annex 4: Unbalanced and Incomplete Financial System

Although quantitative measures financial depth seem to indicate that for the most part China's financial system is on par or even ahead of its economic development (Figure A1), the financial system is unbalanced and incomplete (Figure A1). Although securities markets and insurance companies have grown, they are still dwarfed by the banking system. The banking system itself is unbalanced with the state-owned large commercial banks (SOBs) holding over half of banking sector assets (Table A2). While that share has been declining, the Big Four remain among the ten largest banks in the world.

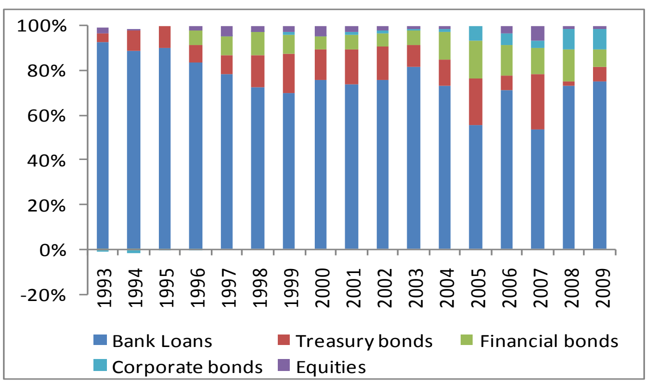
There is also imbalance in the capital markets: stocks dominate as the corporate bond market remains underdeveloped. Stock market capitalization represents 67 percent of GDP, roughly seven times the size of corporate bonds outstanding (Table A1). Viewed through the lens of the share of funds raised, corporate bonds have been growing somewhat in recent years though they still represent only 9 percent of the total. In some recent years, the share of funds raised through bank loans has been as low as 50–60%, but those declines are mostly attributable to increasing shares of fundraising through government bonds and financial bonds (a large proportion of which are policy bank bonds), rather than increases in equities or corporate bonds (Figure A2).

FIGURE A1 Select indicators of financial sector size/depth, 2009



Source: WDI, IFS, BIS, AXCO

FIGURE A2 Funds raised in the financial system (1993–2009)



Source: China Securities and Futures Statistical Yearbook

TABLE A1 Size of sectors/markets

	Assets of banking institutions	Assets of insurance companies	Assets of securities companies	Government bonds outstanding	Financial bonds outstanding	Corporate bonds outstanding	Stock market capitalization
1999	137.0	2.9	-	11.8	7.2	0.9	29.5
2000	138.5	3.4	-	13.1	7.4	0.9	48.5
2001	145.4	4.2	-	14.2	7.8	0.9	39.7
2002	169.8	5.3	-	14.8	8.2	0.5	31.9
2003	179.7	6.7	3.6	18.0	8.7	0.7	31.3
2004	175.0	7.5	2.1	22.4	9.1	0.8	23.2
2005	175.2	8.3	-	27.3	10.8	1.7	17.5
2006	204.0	9.1	-	28.9	12.1	2.6	41.3
2007	179.6	10.9	6.5	32.4	12.7	3.0	123.1
2008	204.3	10.6	3.8	31.3	13.4	4.1	38.6
2009	237.8	11.9	6.0	29.3	15.1	7.1	71.6
2010	241.6	12.7	4.9	28.1	15.0	8.6	66.7

Source: CBRC, CIRC, CSRC, Securities Association of China, BIS
Note: All figures are expressed as a percentage of GDP. Government bonds outstanding include both MOF securities and central bank bills/notes.

TABLE A2 Share of banking sector assets by type of bank (2003–2009)

Group of Institutions	2003	2004	2005	2006	2007	2008	2009	2010
Large State-owned	58.03	56.91	56.06	55.12	53.25	51.03	50.89	49.2
Policy banks	7.68	7.63	7.82	7.90	8.13	9.05	8.82	8.0
Joint-stock bank	10.70	11.54	11.92	12.38	13.78	14.12	14.96	15.6
City bank	5.29	5.40	5.44	5.90	6.35	6.62	7.21	8.2
Rural banks	0.14	0.18	0.81	1.15	1.16	1.49	2.37	2.9
Rural coop.			0.73	1.06	1.23	1.61	1.62	1.6
Urban credit coop.	0.53	0.57	0.54	0.42	0.25	0.13	0.03	0.0
Rural credit coop.	9.58	9.74	8.39	7.85	8.26	8.35	6.97	6.7
Non-bank fin. inst.	3.29	2.76	2.71	2.41	1.85	1.89	1.97	2.2
Postal savings bank	3.25	3.43	3.68	3.67	3.36	3.55	3.43	3.7
Foreign banks	1.50	1.84	1.91	2.11	2.38	2.16	1.71	1.8

Source: China Banking Regulatory Commission annual report 2009

References

Ahmad, S. Ehtisham (2011) "P.R. China: Reforming Public Finances to Meet Advanced Country Challenges." A background paper written for the World Bank.

Allen, F., F. Capie, C. Fohlin, H. Miyajima, R. Sylla, G. Wood, and Y. Yafeh (2011) "How Important Historically Were Financial Systems for Growth in the U.K., U.S., Germany, and Japan?", Pennsylvania Financial Institutions Center Working Paper #10–27

Amsden, Alice H. and Ajit Singh (1994) "The Optimal Degree of Competition and Dynamic Efficiency in Japan and Korea." *European Economic Review,* 38 (3–4): 941–51.

Aziz, Jahangir and Li Cui (2007) "Explaining China's Low Consumption: The Neglected Role of Household Income." IMF Working Paper WP/07/181, July.

Aziz, Jahangir and Steven Dunaway (2007) "China's Rebalancing Act." *Finance and Development 44:3*, September.

Bahl, Roy (2009) "Fixing the Property and Land Tax Regime in Developing Countries." February 25. Draft.

Bai, Chong-En, Chang-Tai Hsieh and Yingyi Qian (2006) "The Return to Capital in China". National Bureau of Economic Research Working Paper 12755, December.

Blanchard, Olivier J. and Francesco Giavazzi (2006) "Rebalancing Growth in China: A Three-Handed Approach." Center for Economic Policy Research, Disucssion Paper DP5403, January.

Boyd, J.H. and B. D. Smith (1998) "The Evolution of Debt and Equity Markets in Economic Development." *Economic Theory, 12*, 519–560.

Brandt, Loren, Johan Van Biesbroeck, and Yifan Zhang (2009) "Creative Accounting or Creative Destruction? Firm-Level Productivity Growth in Chinese Manufacturing." *Journal of Development Economics*, forthcoming.

Brandt, Loren and Xiaodong Zhu (2010) "Accounting for China's Growth." Institute for the Study of Labor Working Paper No. 4764, February.

Bulman, David and Aart Kraay (2011) "Growth in China 1978–2008: Factor Accumulation, Factor Reallocation, and Improvements in Productivity." World Bank, processed, May.

Chen, Shouming, Yong Li, and Deli Cheng (2010) "Industrial Policy in Technology Development", Chemical Industry Press (in Chinese).

Chen, Shiyi, Gary H. Jefferson and Jun Zhang (2011) "Structural change, productivity growth and industrial transformation in China." *China Economic Review* 22, pp. 133–150.

Cook, Paul (2001) "Competition and its Regulation: Key Issues." Center on Regulation and Competition Working Paper No. 2, October.

Deininger, Klaus and Songqing Jin (2009) "Securing Property Rights in Transition: Lessons from implementation of China's rural land contracting law", *Journal of Economic Behavior & Organization* 70, pp. 22–38.

Demirguc-Kunt, Asli, Erik Feyen and Ross Levine (2011) "Optimal Financial Structures and Development: The Evolving Importance of Banks and Markets." Working paper.

Development Research Center of the State Council and World Bank (2005) "Land Policy Reform for Sustainable Economic and Social Development: An Integrated Framework."

Development Research Center of the State Council and World Bank (2008) "Strengthening Land Rights for Equitable Growth and Social Harmony."

Dollar, David and Bert Hofman (2006) "Intergovernmental Fiscal Reforms, Expenditure Assignment, and Governance." Paper presented at the Roundtable Conference on Public Finance for a Harmonious Society, Beijing, June 27–28.

Economist (2011) "Bamboo Capitalism." March 11.

Eichengreen, Barry, Donghyun Park and Kwanho Shin (2011) "When Fast Growing Economies Slow Down: International Evidence and Implications for China." NBER Working Paper 16919.

Ferri, Giovanni and Li-Gang Liu (2009) "Honor Thy Creditors Beforan Thy Shareholders: Are the Profits of Chinese State-Owned Enterprises Real?" Hong Kong Institute for Monetary Research Working Paper No. 16/2009.

Fiscal Reform and Economic Governance (2011) Collecting Taxes Data System, 2009–10. http://www.fiscalreform.net/index.php?option=com_content&task=view&id=759&Itemid=134

Fogel, Kathy, Randall Morck and Bernard Yeung (2007) "Big business stability and economic growth: Is what's good for General Motors good for America?" *Journal of Financial Economics, 89 (1),* pp. 83–108.
Foster, Lucia, John Haltiwanger, and Chad Syverson (2008) "Reallocation, Firm Turnover, and Efficiency: Selection on Productivity or Profitability?" *American Economic Review* 98(1): 394–425.
Gerschenkron, A. (1962) Economic Backwardness in Historical Perspective. Cambridge, MA: Harvard University Press.
Gill, Indermit and Homi Kharas (2007) *An East Asian Renaissance—Ideas for Economic Growth.* Washington DC: The World Bank.
He, Jianwu and Louis Kuijs (2007) "Rebalancing China's Economy—Modeling a Policy Package", World Bank China Research Paper No. 7.
Hofman, Bert and Jinglian Wu (2009) "Explaining China's Development and Reforms" Commission on Growth and Development Working Paper No. 50.
Hsieh, Chiang-Tai and Peter Klenow (2009) "Misallocation and Manufacturing TFP in China and India". *Quarterly Journal of Economics.* 124(4):1403–1448.
Hu, Jiangyun (2008) "Industrial Policies and the Development of China's Large Auto Groups". In Wenkui Zhang (*ed.*) 2007 Annual Report of the Development of China's Large Enterprise Groups, China Development Publishing House, 2008 (in Chinese).
Huang, Yiping (2010) "Dissecting the China Puzzle: Asymmetric Liberalization and Cost Distortion." *Asian Economic Policy Review 5*, pp. 281–295.
Huang, Yiping, and Bijung Wang (2010) "Cost Distortions and Structural Imbalances in China" *China & World Economy*, Vol. 18, No. 4.
Huang, Yiping and Kunyu Tao (2010) "Causes and Remedies of China's External Imbalances." China Center for Economic Research Working Paper No. 2010–02.
Huang, Yukon (2011) "Background Note: China's Policy Reforms—Why They Worked." Processed, April 26.
Jacoby, Hanan, Guo Li and Scott Rozelle (2002) "Hazards of Expropriation: Tenure Insecurity and Investment in Rural China," *American Economic Review.* Vol. 92(5)
Jiang, Feitao and Xiaoping Li (2010) "Market Intervention Directly and Competition Restriction: the Orientation and Fundamental Flaws of China's industrial Policy." *China Industrial Economics, 2010(9).* (in Chinese).
Jiang, Xiaojuan (2010) "Institution reform and industrial development—Studies on courses and cases", Beijing Normal University Publishing. (in Chinese).
Jin, Songqing and Klaus Deininger (2009) "Land rental markets in the process of rural structural transformation: Productivity and equity impacts from China." *Journal of Comparative Economics 37*, pp. 629–646.
Kuijs, Louis (2010) "China Through 2020—a Macroeconomic Scenario", World Bank China Research Working Paper No. 9.
Kuijs, Louis and Gao Xu (2008) "China's Fiscal Policy—Moving to Center Stage." Paper written for the Stanford Center for International Development conference on Social Services, Regulation and Finance.
Kuijs, Louis and Tao Wang (2006) "China's Pattern of Growth, Moving to Sustainability and Reducing Inequality", *China and the World Economy,* January 2006.
Landesa (2011) "Preliminary Survey Findings on Chinese Farmers' Land Rights and Future Reforms", presentation slides.
Lardy, Nicholas R. (2007) "China: Rebalancing Economic Growth". In *The China Balance Sheet in 2007 and Beyond* (Washington, DC: CSIS and Peterson Institute for International Economics).
Lee, Jong-Wha and Kiseok Hong (2010) "Economic Growth in Asia: Determinants and Prospects." Asian Development Bank Working Paper Series No. 220, September.
Leipziger, Danny M. and Vinod Thomas (1993) *The Lessons of East Asia: An Overview of Country Experience.* (Washington, DC: The World Bank).
Leipziger, Danny M., Claudio Frischtak, Homi J. Kharas and John F. Normand (1997) "Mercosur: Integration and Industrial Policy."
Li, Guo (1999) The Economics of Land Tenure and Property Rights in China's Agricultural Sector. Unpublished Ph.D. dissertation, Stanford University.
Li, Shaomin and Jun Xia (2008) "The roles and performance of state firms and non-state firms in China's economic transition." *World Development* 36, No. 1, pp. 39–54.

Lin, Justin Yifu (1992) "Rural Reforms and Agricultural Growth in China." *American Economic Review*, 82, No. 1, March, pp. 34–51.
Lin, Justin Yifu (2010) "The China Miracle Demystified." Paper presented at the Econometric Society World Congress, Shanghai, August 19.
Lin, Justin Yifu (2011) "China and the Global Economy." Remarks at the 20th Anniversary of the Hong Kong University of Science and Technology, March 23.
Liu, Lili (2010) "Strengthening Subnational Debt Financing and Managing Risks." *Review of Economic Research;* Ministry of Finance, China; August 16, 2010, 46 F-9. Beijing.
Liu, Lili and Juan Pradelli (2011) "China Financing Infrastructure and Monitoring Fiscal Risks at Subnational Level: Strategic Considerations and Policy Options." Forthcoming Policy Note, World Bank Beijing Office.
Liu, Lili and Steven Webb (2011) "Laws for Fiscal Responsibility for Subnational Discipline: International Experience." *World Bank Policy Research Working Paper, #5587.*
Liu, Shijin (2008) "Market Openness, competition and industrial advancing—debates and important experience in past 30 years of China's auto industry." *Management World, 2008(12).* (in Chinese).
Liu, Xiaoxuan and Xiaoyan Zhou (2009) "How the Financial Resources are Allocated to the Real Economy in China — Test for Relationships Between the Financial and Industrial Sector." Working paper.
Luo, Xubei (2005) "Growth Spillover Effects and Regional Development Patterns: The Case of Chinese Provinces", *World Bank Policy Research Working Paper*, #3652. Washington, DC: World Bank.
Ma, Guonan and Wang Yi (2010) "China's high saving rate: Myth and reality." BIS Working Papers No. 312, June.
Manning, Nicholas and Neil Parison (2004) "Determining the Structure and Functions of Government: Program and Functional Reviews". WB Russia CSR team Working Paper 36135.
Ministry of Finance (2011) "Report on the Implementation of the Central and Local Budgets for 2010 and on the Draft Central and Local Budgets for 2011." Presented to the Fourth *Session of the Eleventh National People's Congress, March 5.*
Ministry of Finance. "Finance Yearbook of China." (《中国财政年鉴》 in Chinese.) various issues. China Finance Publishing House. Beijing.
Mullan, Katrina, Pauline Grosjean and Andreas Kontoleon (2010) "Land Tenure Arrangements and Rural-Urban Migration in China." *World Development, 39 (1)*, pp. 123–133.
National Bureau of Statistics. "China Statistical Yearbook." Various issues. China Statistical Publishing House. Beijing.
Naughton, Barry (2007) "China's State Sector, Industrial Policies and the 11th Five Year Plan." Testimony before the US-China Economic and Security Review Commission Hearing, May 24.
Naughton, Barry (2011) "What Price Continuity?" *China Leadership Monitor 34.*
OECD (2006) "Current Situation of the Chinese Steel Industry." Report DSTI/SU/SC(2006)9
OECD (2010) *Economic Survey of China 2010* (Paris: Organisation for Economic Cooperation and Development).
Ou, Xinqian and Jiang Liu (2007) *China's industrial development and industrial policy.* (Beijing: Xinhua Press) (in Chinese).
Owen, Bruce and Wentong Zheng (2007) "China's Competition Policy Reforms: The Antimonopoly Law and Beyond." Stanford Institute for Economic Policy Research Discussion Paper No. 06-32.
Pan, Jane (2010) "Focus: China's private airlines." http://www.flightglobal.com/articles/2010/05/18/342125/focus-chinas-private-airlines.html
Ravallion, Martin and Shaohua Chen (2004) "China's (Uneven) Progress Against Poverty." World Bank Policy Research Working Paper No. 3408.
Rosenstein-Rodan, P.N. (1961) "Notes on the Theory of Big Push", in H. Ellis and H. Wallich, eds., 1961.
Rozelle, Scott and Guo Li (1998) "Village Leaders and Land-Rights Formation in China." *American Economic Review, Vol. 88,* No. 2. Pp. 433–438.
Schmitt, Ulrich (2011) "China: Land Policies for a Harmonious, High Income Society." Background paper for this report. July.
Schneider, Jacob (2010) "Administrative Monopoly and China's New Anti-Monopoly Law: Lessons from Europe's State Aid Doctrine." *Washington University Law Review 87*, pp. 869–95.
Shi, Yaodong and Zhonghong Wang (2011) "Evaluation on China's industrial policy—Based on Auto Industry." DRC internal report, January. (in Chinese).
Song, Zheng Michael, Kjetil Storesletten and Fabrizio Zilibotti (2009) "Growing Like China." CEPR Discussion Paper No. 7149, January.

State Information Center (2007) "Energy Saving and Emission Reduction: the New Start of China's Industrial Policy", Working Paper (in Chinese).
Stern, Nicholas (2011) "Raising Consumption, Maintaining Growth and Reducing Emissions." Paper for China Development Forum, March.
Sutherland, Dylan and Lutao Ning (2008) "Exploring and Explaining the Extent of Concentration and Diversification in Chinese Business Groups". Processed.
Tian, Lihui (2007) "Does government intervention help the automobile industry? A comparison with the Chinese computer industry." *Economic Systems 31*, pp. 364–74.
UNCTAD (2002) "Application of Competition Law: Exemptions and Exceptions". UNCTAD/DITC/cLP/Misc.25
Vincellette, Gallina, Alvaro Manoel, Ardo Hansson and Louis Kuijs (2011) "China: Global Crisis Avoided, Robust Economic Growth Sustained. In Mustapha K. Nabli, *ed., The Great Recession and Developing Countries: Economic Impact and Growth Prospects* (Washington, DC: The World Bank).
Wang, Hui, Tan Tao and Joyce Yanyun Man (2010) "To Reallocate or Not? Reconsidering the Dilemma for China's Agricultural Land Tenure Policy", Peking University—Lincoln Institute Working Paper Series No. 040, October.
Weiss, John (2005) "Export Growth and Industrial Policy: Lessons from the East Asian Miracle Experience." ADB Institute Discussion Paper No. 26, February.
Westphal, Larry E. (1990) "Industrial Policy in an Export-Propelled Economy: Lessons from South Korea's Experience." *Journal of Economic Perspectives 4,* No. 3, Summer, pp. 41–59.
World Bank (2006) "Fiscal Policy for Growth and Development: An Interim Report." Washington, DC: World Bank
World Bank (2007) "China: Improving Rural Public Finance for the Harmonious Society." Washington, DC: World Bank
World Bank (2009a) From Poor Areas to Poor People: China's Evolving Poverty Reduction Agenda; An Assessment of Poverty and Inequality in China. (Washington, DC: The World Bank)
World Bank (2009b) "GET Note: Functional Reviews & Alternative Service Delivery". "Recently Asked Questions" Series 53458, August 2009, Washington, DC: World Bank
World Bank (2009c) *Mid-Term Evaluation of China's 11th 5 Year Plan*. (Washington, DC: The World Bank)
World Bank (2009d) World Development Report 2009: Reshaping Economic Geography. (Washington, DC: The World Bank)
World Bank (2010a) "Effective Discipline with Adequate Autonomy: the Direction for Further Reform of China's SOE Dividend Policy." Policy Note.
World Bank (2010b) China Land Transfer and Registration Technical Assistance: Report on Survey of Rural Households and Other Stakeholders in Anhui and Shandong Provinces.
Wu, Jianglian, Junkuo Zhang, and Shijin Liu (1998) "The Strategic Restructuring of the State Sector", China Development Press. (in Chinese).
Xiang, Anbo (2011) "Growth and Strategy Variance of China's Emerging Large-scale Enterprise", working paper. (in Chinese).
Xu, Shanda (2006) "On the Consistency of Tax Attribution and Tax Source", paper presented on the High-level Roundtable Conference of Public Finance and Building a Harmonious Society, Beijing, June 27–28, 2006 (in Chinese).
Yang, Weimin (2004) Research on Integrated Policies for China's Sustainable Industrial Development. China Market Press. (in Chinese).
Yuan, Lei (2010) "The effectiveness evaluation of 10 industrial adjustment and promotion plans", *China Economy and Trade Magazine* (zhongguo jingmao daokan), October (in Chinese)
Yusuf, Shahid and Kaoru Nabeshima (2010) *Changing the Industrial Geography in Asia* (Washington, DC: The World Bank)
Zhang, Wenkui (2010) "The Direction and Task for China's SOEs Reform in the 12th five-Year Plan Period", DRC Research Report, No. 203. (in Chinese).
Zhang, Xiaobo and Kong-Yam Tan (2007) "Incremental Reform and Distortions in China's Product and Factor Markets." *The World Bank Economic Review 21* (No. 2), pp. 279–99.
Zhao, Min (2011) "China: Fiscal Policies for a Harmonious, High Income Society." Background paper for this report. July.