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## China's Changing of the Guard

# STATE CAPACITY ON THE REBOUND

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Despite China's stellar record of economic growth since the late 1970s, skepticism about the country's future abounds. Serious questions have been raised about the picture created by China's economic statistics and, by extension, about its growth record.<sup>1</sup> Even if we accept the official statistics at face value, conventional wisdom holds that China faces daunting challenges in creating jobs, shoring up its shaky banking system, dealing with rising income inequality, and protecting the environment. While an increasing number of Chinese cities, particularly along the coast, have become global manufacturing centers, unemployment among state-sector workers has skyrocketed. In recent years, the rural population has fallen on especially hard times from the triple whammy of a prolonged slump in farm prices, a major slowdown in non-farm employment creation, and local-government rapacity. For these reasons, it has become almost *de rigeur* to speak of China as being in crisis.

Yet more than a decade after the Soviet Union fell apart, the Chinese Communist Party (CCP) remains in power. On the surface, the Chinese leadership appears to have weathered the myriad challenges it has faced by sticking to its roots. Aside from beefing up its coercive apparatus, the leadership has kept tight control over the *nomenklatura* system, placing trusted lieutenants in key positions and rotating officials to prevent them from building personal fiefdoms. The opacity with which the ongoing political succession has been conducted seems to underscore just how much the Party has resisted changing with the times.<sup>2</sup>

Beneath the surface, however, China's leaders have worked furiously over the past decade to remake the institutions of governance. Leaving aside the promotion of elections in villages and urban neighborhoods (as these are not part of the state apparatus), the central leadership has dramatically revamped the fiscal and tax systems to strengthen the central state's revenue base over the long haul. It has also launched a major restructuring of the government and strengthened its regulatory institutions in the interest of promoting orderly market competition and financial stability. Yet the drive for a more effective state has been coupled with serious initiatives to curb bureaucratic discretion and rent-seeking and strengthen horizontal accountability.

### **The Center and the Purse Strings**

While the post-Tiananmen leadership took up Deng's call for reforms, its first order of business was to rebuild the central government's fiscal sinews, which had been enervated by particularistic arrangements (namely, fiscal contracting between the center and the provinces) in the first decade of reforms. Leveraging the Party's political and organizational resources, China's central leaders pushed through comprehensive tax and fiscal reforms in 1993–94. These reforms replaced the country's particularistic fiscal-contracting system with a modern tax-assignment system.<sup>3</sup> In contrast to the old system, which had given the central government only a set amount of revenue, the new system designates different categories of taxes to the central and local governments, respectively—in a way similar to the federal taxation schemes used in a number of Western countries—so that central-government revenues grow along with the economy.

The implementation of these tax and fiscal reforms, coupled with the construction of a separate tax administration for the central government, quickly raised the central government's share of budgetary revenue—relative to that of the provinces—to 55.7 percent in 1994, up 33.7 percentage points from a year earlier. It remained at 52.4 percent in 2001. At the same time, total government budgetary revenue as a percentage of GDP has also recovered substantially, rising from a low of 10.7 percent in 1995 to 17.1 percent in 2001.<sup>4</sup> Whereas much of the increased central revenue finds its way back to the provinces as rebates and transfer payments, the central government's effective control over the revenue stream has gotten much stronger—a fact that has undergirded the Chinese government's fiscal stimulus program in recent years and made possible major increases in social spending, including the doubling of civil servants' and retirees' salaries between 1998 and 2002; the provision of basic livelihood stipends to nearly 20 million people in 2002, up from 4 million at the end of 2000; and a major initiative to turn farm fields back into grasslands and forests in western China.

While the 1993–94 fiscal and taxation reforms introduced elements of fiscal federalism, the overall reforms were clearly intended to enlarge the central government’s share of total government revenue. Subsequent developments—including limits on the power of local authorities to offer preferential tax treatment and tax rebates to companies, the central government’s virtual takeover of the securities-trading tax, and the reapportionment of corporate and personal income taxes in favor of the center—have repeatedly demonstrated that it is the central government that calls the shots. As far as fiscal matters are concerned, China is far from being genuinely federal.

Take the revenue from the individual income tax, for example, which was assigned to local authorities as part of the 1994 fiscal reforms. This decision ran counter to global trends: As globetrotting corporations find numerous ways to reduce their tax burdens, central governments in developed countries tend to rely for revenue on the personal income tax. To be sure, at the time of the 1994 reforms, the amount of personal income tax revenue in China was quite small and difficult to collect. By 2001, though, this revenue had risen on the tide of economic growth to become one of the government’s top four sources of revenue. Faced with the need to fund various reform measures, the central government told local authorities in 2001 that it would take a share of both the personal income tax revenue and the corporate income tax. The center’s share is set at 50 percent for 2002 and 60 percent for 2003, with future rates to be set in light of circumstances.<sup>5</sup>

The reallocation of the personal income-tax revenue underscores the center’s dominance in central-provincial fiscal relations. The central leadership has justified the move by saying that it will use its additional revenue to boost transfer payments to the interior regions (at a time when the central government is constrained from expanding the scale of deficit financing).<sup>6</sup> The less-developed areas were more supportive of the 1993–94 fiscal reforms than were the coastal provinces, and the continuing changes have made the less-developed provinces even more dependent on the central government’s largesse. Over time, the redivision of income tax revenue, along with the general reconfiguration of the country’s fiscal structure that has been underway for a decade now, may significantly expand the central government’s fiscal prowess—just as the expansion of the personal-income tax in the United States greatly facilitated the expansion of the federal government after the Second World War.

### **Reconfiguring the State**

While China’s leaders have strengthened the state’s fiscal foundations, they have also engaged in a series of attempts to remake the state—originally constructed for Soviet-style planning—to suit market conditions. The latest and most comprehensive round of government

reforms began in 1998 and is still being implemented at the county and township levels. On the surface, this reform drive has focused on downsizing and streamlining the government. Between 1998 and mid-2002, the authorized staff size in all Party, government, and government-sponsored mass organizations was reduced by 1.15 million. And governments at the municipal, county, and township levels laid off an additional 430,000 employees.<sup>7</sup> In percentage terms, the central and provincial administrative staffs were cut by just under 50 percent—an impressive figure even by the standards of U.S. corporate downsizing. The size of county and township government staffs is being reduced by just under 20 percent as of 2002.

More importantly, the government structure has been reconfigured much more closely along the lines of a regulatory state. The major Soviet-style industrial ministries, also known as the “line ministries,” have been scrapped while regulatory agencies—including the administrations for industry and commerce; environmental protection; quality and technical supervision (now the State Administration of Quality Supervision, Inspection, and Quarantine); pharmaceutical supervision; intellectual property; and workplace safety—have been augmented or created. Working alongside the powerful State Economic and Trade Commission and the State Development Planning Commission, complemented by nongovernmental organizations such as the Chinese Consumers’ Association, these agencies are charged with the enforcement of state laws on patents, copyrights, trademarks and brand names, the environment, quality and technical standards, production safety, and the protection of consumer rights.

As when Upton Sinclair and the muckraking journalists captured the imagination of consumers and lawmakers during the Progressive Era in the United States nearly a century ago, exploding beer bottles and dangerous water heaters are now regular fare in the Chinese media, catching the attention of consumers and government leaders alike. In response to popular demands and national economic interests, the Chinese leadership has made the promotion of unified, effective regulatory agencies a major focus. While previously the regulatory agencies were beset with local protectionism (particularly the dominance of local interests in their field offices), each of the major regulatory agencies has adopted vertical administrative methods to promote agency integrity. Under this model, the personnel and budgets of field offices are controlled by superior (generally provincial) levels of the regulatory agency rather than subsumed under the local government.

Armed with more administrative muscle and strong legislative mandates, the regulatory agencies have become more assertive, conducting more searches and giving out stiffer penalties to violators. In spring 2001, the central leadership pooled the initiatives of the individual regulatory agencies into a national drive to clean up irregularities in the economic order. That year, authorities shut down half a million workshops produc-

ing fake products, and confiscated 158 million illegal publications and 4.2 million copies of pirated software.<sup>8</sup> Much remains to be done, and China's rapid growth has brought to the fore new problems (for example, complaints about automobile, computer, and housing purchases). As Vice Premier Li Lanqing, head of the Leading Group in Charge of National Rectification and Standardization of Market Economic Order, noted, the quest for orderly market competition will be "protracted, difficult, and complex."<sup>9</sup> Taking consumer complaints into account, however, the national drive for more stable and transparent markets, as well as the effects of market competition and growing consumer savvy, have helped to address longstanding concerns about quality: The China Consumer's Association received 309,231 consumer complaints in the first half of 2002, down 8.9 percent from the previous year.<sup>10</sup>

### Curbing the Government

These developments have all occurred on the CCP's watch. Government reform and de facto privatization have been accomplished not by dismantling state power but by reconstituting it. The central state now has *more* fiscal capacity and is *more* capable and effective generally. These reforms are vitally necessary for the provision of basic services, the maintenance of order, and the sustenance of conditions for economic growth—all basic aspects of governing capacity that are often lacking in countries at China's level of economic development. Indeed, over the quarter-century since Mao's death, the Chinese mainland has witnessed its longest period of stable economic development since the late nineteenth century.

Yet for a classical liberal, such developments beg the question: For what ends ought the state's enhanced governing capacity be used? Examining China's reforms in light of this question, we find a much more variegated ideological landscape than is commonly associated with CCP dictatorship. Even before the 1998 reforms began, the idea of "small state, big society" had gained substantial influence. It served as the guiding doctrine for experiments in the southern island province of Hainan in the late 1980s and has since been emulated by other local authorities and become part of the Chinese lexicon. With the progression of the reforms launched in 1998, the Chinese media, including the *People's Daily*, now find it uncontroversial to mention the need to move from "totalistic administration" (*quanneng xingzheng*) to "limited administration" (*youxian xingzheng*), or to use the term "limited government" (*youxian zhengfu*). In general, the Chinese elite now appear to take it for granted that the power of government must be delimited, frequently referring to "administration in accordance with law" (*yifa xingzheng*) as a shorthand for putting limits on what the government can do.

How have these ideas fared in practice? It hardly needs to be said that

China's remains far from the typical limited government known in the West, particularly when it comes to political dissidence. Yet a variety of developments do indicate serious efforts to constrain government power. For one, governmental downsizing and streamlining have been complemented by major initiatives to curb officials' discretion, boost transparency, and promote the idea of government as a form of public service. On the basis of the view that government should concentrate on doing fewer things but doing them better, there has been a systematic program aimed at reducing the number of items requiring administrative approval and licensing, while most provincial authorities have cut the number of administrative-approval items by half. Meanwhile, the transparency of government policies has improved, spurred by China's entry into the World Trade Organization (WTO) and aided by the Internet: Not only do government departments generate documentation and information as never before,<sup>11</sup> but there are now standard operating procedures for holding public hearings on public-utilities pricing—with some noticeable effects on the prices that are set—and for allowing ordinary citizens to observe sessions of local people's congresses. Most prominently, the Chinese Securities Regulatory Commission, whose decisions affect the wallets of tens of millions of investors, now regularly solicits public comments before putting new regulations in effect. Local governments have also rushed to set up one-step government service centers to process business applications more efficiently and reduce bureaucratic rent-seeking. By 2003, the concept of government service has extended to interactions with citizens—with, for example, reforms being introduced to make it easier to get a passport or a vehicle license plate.

It is in government-business interactions, however, that China's governance style has changed the most in recent years. Besides accepting the terms of China's WTO membership, which requires the Chinese government to boost transparency and phase out all trade quotas in a few years' time, the Chinese leadership, in 1998, launched a dramatic and successful divestiture of commercial businesses owned by the military, the armed police, judicial institutions, as well as the Party and the legislatures. Since then, Beijing has scrapped the quotas for listing companies on securities markets; aggressively promoted the adoption of competitive bidding and tendering for construction projects and government procurement (now governed by the Government Procurement Law enacted in July 2002); and mandated the use of auctions for the allocation of land for commercial use. And the Ministry of Finance is now engaged in a massive reform of budget and expenditure processes. All these and other measures have helped level the economic playing field and sharply reduce the opportunities for rent-seeking and, by extension, the incidence of official corruption.

It is worth noting that the initiatives to place limits on government behavior are increasingly embedded in institutional mechanisms and

codified in laws. The governmental reforms that have been carried out have made it easier for Beijing to accept terms of WTO membership, which in turn has forced the government to expand and accelerate certain aspects of the reforms. The experiments with official-procurement reforms resulted in the enactment of the Government Procurement Law in mid-2002, which has made competitive bidding and tendering the accepted practice. At the same time, the rise of the National Audit Office and the strengthening of supervision demanded by National People's Congress delegates have reinforced the developments discussed here. Legislative initiatives at the national and subnational levels have already led to more careful, if still limited, scrutiny of government budgets and reinforced efforts to reform public finance. In late August 2002, the National People's Congress began considering drafts of long-awaited laws providing for legislative supervision of administrative and judicial bodies, and sharply curbing the power of government ministries and local bureaus to impose administrative-approval requirements on businesses and citizens. Once they are in place, both these laws should contribute considerably to China's trend toward horizontal accountability.

In China, crisis has been the midwife of reform. Faced with multiple challenges, the country's leaders have been on a perpetual drive since the late 1980s to improve governance and rebuild the fiscal prowess and institutional sinews of the central state, often themselves invoking the rhetoric of crisis in the process. And they have taken painful measures to improve the long-term viability of the system: Employment in urban state units, for example, was reduced by a whopping 30.8 percent, from 110.4 million in 1997 to 76.4 million in 2001. Even in 2002, and notwithstanding conventional press reports of stagnation in reforms, there are major initiatives underway to broaden the social security system, expand support for the urban indigent, and make rural fees and taxes less burdensome to farmers.

Most importantly, the initiatives to improve the efficiency, transparency, and accountability of the administrative state, while still unevenly adopted across the country, may prove the most enduring legacy of the current age. In the short and intermediate run, such reforms help bridge the gap between the elite and the masses, and go some way toward curbing rampant rent-seeking. In the long run, an efficient and well-governed administration will be indispensable if and when elite politics do make a democratic transition. As Samuel P. Huntington famously noted several decades ago, "Organization is the road to political power, but it is also the foundation of political stability and thus the precondition of political liberty."<sup>12</sup>

## NOTES

1. See Thomas Rawski, "What's Happening to China's GDP Statistics?" *China Economic Review* 12 (December 2001): 347-55.



2. See also Andrew J. Nathan and Bruce Gilley, "China's New Rulers: 1. The Path to Power," *New York Review of Books*, 26 September 2002. On the basis of secret files from the Chinese Communist Party's Organization Department, Nathan and Gilley conclude that the CCP has the ability to renew itself at the top.

3. For further analysis, see Dali Yang, "Economic Crisis and Market Transition in the 1990s," in Edwin Winckler, ed., *Transition from Communism in China: Institutional and Comparative Analysis* (Boulder, Colo.: Lynne Rienner), 151–77.

4. These figures are derived from the latest available data from the National Bureau of Statistics. The revenue figures exclude debts.

5. The percentages are set for amounts above the 2001 base figures.

6. "PRC Officials on Income Tax Revenue Sharing Scheme Aimed at Common Prosperity," *Xinhua* newswire, 12 March 2002; "Finance Minister Xiang Huaicheng Says Revenue Sharing To Benefit Western China," *Xinhua* newswire, 11 March 2002.

7. *Renmin Ribao* (People's Daily), overseas ed., 20 June 2002.

8. "China to Continue to Improve Market, Economic Order," *Xinhua* newswire, 24 January 2002.

9. "Li Lanqing Addresses Meeting on Rectifying Market Economic Order," *Xinhua* newswire, 24 June 2002.

10. *Xinhua* newswire, 13 August 2002.

11. See, for example, [www.setc.gov.cn](http://www.setc.gov.cn) and [www.sdpc.gov.cn](http://www.sdpc.gov.cn), the websites of the State Economic and Trade Commission and the State Development Planning Commission, China's two most powerful economic agencies.

12. Samuel P. Huntington, *Political Order in Changing Societies* (New Haven: Yale University Press, 1968), 461.