

THE CHINESE GOVERNMENT: CENTRAL CONTROL VS. DECENTRALIZATION

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Background

General reform of the economy of the People's Republic of China began in the mid 1980s as a reluctant retreat from the old style command and control economy toward a market based economy. Reform was driven by the growing recognition that state socialist economic policy was a failed experience, and would never produce the high levels of economic growth and development that would even keep up with population growth, much less permit any extensive improvement in China's economic strength or citizen quality of life. Nor was the Communist China Party, (CCP) making a success of the "allocation of scarcity" which is all that their economy provided. Inherent in the centrist state system was the widespread use of State Owned Enterprises (SOEs) which were instruments of the government, but supposedly free to operate much like independent organizations capable of operating profitably in the realistic world. But SOEs too had proved failed experiences. Instead of generating revenue for government use, most had proved inefficient, and many operated at deficits that had to be underwritten by the government, using funds that could be utilized elsewhere. SOEs carried larger overhead costs because they provided many social services to their employees such as housing, health care, pensions and elementary/secondary education, and these direct costs drained much of their profitability.

During the period of the late 1980's and the 1990's other major tides reinforced the need for urgent reform. The collapse of the Soviet Union, largely through the failures of its command and control economy badly shook Chinese leadership, and helped the reform minded in the Party to overcome the inertia and resistance of the older leadership. The Asian economic crisis of 1998-1999 resulted in the collapse of regimes in Southeast Asia, and further worried the Chinese leadership. As a result, it further expedited two reactions. First, it persuaded the leadership to divert money from some heavy industrial development for channeling into domestic public infrastructure and social services physical plant such as schools and hospitals. Second, it reinforced and galvanized a much publicized anti-corruption campaign driven from the Party on down through the national bureaucracy and into the provinces, townships and municipalities. Both of these programs were designed to divert growing public distrust. The Party deliberately set out to establish themselves as the "heroes" in the reform of the very corrupt and incompetent governance that they themselves had created. The chosen "villains" were to be the bureaucracy,

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the provinces and other local governments, and in truth, there were plenty of real villains to catch.

Finally, the negotiations of the Chinese government to be accepted into the GATT and the WTO system made it clear that reform was a pre-condition of that acceptance. In addition, many potential foreign investors also made it clear that their willingness to invest in the Chinese economy rested on at least a minimum of reforms that would protect their investment commitments. Deng Xiaoping recognized that there were limits as to what funds could be squeezed out of the peasants, and saw foreign direct investment as a vital “shot in the arm” to precipitate a development surge.

A Legacy of Neglect

In the period from 1985 to 1996, the Party and the central government pressed a process of devolution of power and control over many public programs to the provinces and municipalities but deliberately withheld the funds that would pay for these programs, telling the governors and city councils that they had to find their own sources of funds. Second, they transferred many of the national SOEs into the hands of provincial governors and municipal and township/county councils in addition to those already held without the introduction of any real controls. Since these SOEs were often providers of certain social services, this further expanded local government roles. Decentralization ended up making everything worse, and the Chinese government has been forced to play “catch-up” with its own follies. An old guard clung to the view that centrist control should never be relinquished, and even the reformists were uncertain what the disaggregation of power would produce.

The failures of the economy have left a huge population of unemployed and underemployed. There is an estimated 180 million people who cannot find work, or are in the informal economy, or are unauthorized workers in urban areas, who are in temporary, part time or seasonal jobs who seek more permanent employment. In addition, 10-12% of official workers (20-25 million) are unemployed at any given time.¹ Every level of government is urgently trying to find ways to provide job opportunities, but there is increasing concern that development is uncontrolled and it is driving up prices, creating problems of overproduction and adding to rampant corruption. And governments face a special dilemma: even while they are attempting to provide jobs, it remains to their advantage to have a pool of cheap labor because it gives them an economic advantage, and competition for jobs without socialist fringe benefits keeps labor rates low.

There are other massive accumulated challenges facing those who are attempting to reform governments. By developed country standards, most social programs are pitifully inadequate. Less than 16% of the rapidly aging population has any form of retirement insurance, and even when available, insurance provides only about 25% of need. Only about 14% have health insurance, and illness or accident can often drive people into bankruptcy.² Elementary/secondary education is now more fully available, but it still rests too greatly on

¹ Center for Strategic and International Studies (CSIS), “China: The Balance Sheet”, p. 32.

² OECD report, “Governance in China”, 2005. See also Pei, Minxin, “China’s Trapped Transition”, 2006

The Chinese Government: Central Control vs. Decentralization

heavy fees paid by parents. Most public infrastructure remains seriously inadequate, especially in rural and village areas. Economic development has caused explosive worsening of environmental hazards. China has 16 of the 20 most polluted cities in the world³. There are thousands of areas of very high and often dangerous pollution such as runoffs from industries and irrigated fields, mine sites, burning of coal and wood, and heavy river and underground water pollution. Again, the political leadership faces a dilemma: China uses huge amounts of soft coal that is one of the main polluters of the atmosphere. But if coal use is reduced, the Chinese will have to buy more and more expensive oil and gas in an increasingly competitive 21st century world market. The burgeoning population, the demand for better and more varied diets, and the shortage of farm land has ended any hopeful policy of food self sufficiency and made China a large scale food importer.

Local governments face serious gaps in the social services safety net. There has been a necessary shift of social services from the SOEs to local governments. But in health care for example, 86% of care financing is still by the individual, and 56% of total health care costs are patient costs. There is little provision for public health and sanitation (available to less than 44% of the population), clean water is available for only 23% of the people, and the country is highly vulnerable to epidemics⁴. There are 134 million elderly over 60 in China – the world's largest elderly population⁵.

The cumulative consequences of these long term short comings demonstrate with great force the fact that highly centrist and centrally planned and controlled governance simply did not work very well. The CCP is thus being forced to decentralize at least government operations whether it wants to or not. But the CCP and the central bureaucracies are not decentralizing two other factors of governance: central policy and political control, and central bureaucratic control by more subtle and indirect means. The Party and the government are undertaking more realistic and desirable policy and funding shifts, but while they brag about the 15-20% of the problems they are impacting, they are left with over a billion people whose needs they cannot now conceivably satisfy. Nobody in human history has ever tackled such an enormous task.

Organizational Reforms

The Chinese government structure is surely one of the most complicated of any government in the world, and one of the most inefficient. It was allowed to burgeon out of control for decades, and it was used to promulgate communist theology, exert centrist control, enforce all kinds of extraordinary policies, provide employment for millions of Party members and faithful hangers-on, and only secondarily to deliver wholly inadequate public programs. The Chinese Communist Party (CCP) maintains a whole government-wide top to bottom structure of offices independent from the official bureaucracy and vested with almost total control over the bureaucracy at all levels down to villages. At the center is the National People's Congress (NPC), with its executive authority vested in a powerful Central Committee. The NPC elects

³ CSIS, *op cit.* p. 54

⁴ *Ibid.*, pp.38-40

⁵ *The Economist*, August 2007. Pei, *Op cit* 2006

China's President who in turn appoints the Premier, and these two head an elite and all powerful State Council.

Then there are the official ministries – currently 20 of them – which view themselves as “in charge” of their sectors of the economy and society. Most ministries then supervise a complex substructure of State Owned Enterprises (SOE) plus what are generally called Public Service Units (PSU) which are a large range of enterprises serving public purposes such as technical schools, hospitals, engineering organizations and many others. The reform, rationalization and divestiture of SOEs has been one of the most important and most traumatic structural modifications, since it involves creation of a great deal of unemployment, and the transfer of their social services roles to local governments.

This array of institutions established at the national government level is usually repeated down through a hierarchy of provinces, counties, townships, municipalities and villages, with each lower level accountable to the one above it.

As with most governments, there is a group of “cross-cutting” agencies with government-wide authority such as the Ministry of Finance (revenues and budgets), the People's Procuratorate (law enforcement), the court system, a National Audit Office, a National Development and Reform Commission, and a special commission to supervise state owned assets.

Since about the mid-80s, it has been one of the most significant and persistent patterns of reform to “rationalize” this huge, complicated and wasteful institutional architecture, and it is clear that, in structural terms, decentralization is winning out over the older yearning for central control. More than 200 subunits of government have been eliminated in the central ministries alone. The top down grip on even the most routine processes and procedures has been broken, and there is a new willingness to permit decentralization of operations.

In addition, a series of special task forces has been making serious assessments – often for the first time – of bureau operations, and thousands of them have proved to be unauthorized, improper, unneeded, obsolete, harmful, time consuming and thus easily terminated without adverse consequences. This in turn facilitated another major goal of reform: the downsizing of the bureaucracy. There had grown up a huge “redundancy factor” – that is, people on the payroll with no “real” jobs. Much of this redundancy was politically inspired as a form of patronage and reward for the faithful. By eliminating this redundancy, rationalizing the structure, cleaning up process waste, duplication and overlap of functions, at least 1.8 million people were removed from the roles with little impact on agency performance⁶. These reforms were accompanied by fundamental reforms in the major management systems of the government, discussed later in this article. It should also be noted that a similar program of reform was simultaneously carried out in the People's Liberation Army (PLA).

But one major point must be emphasized. In the eyes of practiced bureaucrats, it seems clear that every single reform activity has been conceived, designed, and implemented in ways

⁶ An extensive assessment of reduction in government and party employment can be found in Yang, Dali L., Remaking the Chinese Leviathan, Ch.2, pp. 25-64

that have yielded the greatest power retention by the political leadership. In fact, many reforms have greatly strengthened central power as would “global warming” in the West.

Construction Reforms

Of the many reforms that the government has instituted, none has been more necessary than in the arena of government contracting, including construction, land use and land leasing, and letting of contracts for purchase of goods and services. Contracting has also been central to the abilities of local governments to move state owned enterprises from incompetence and financial losses into the realm of profitable operations.

But until recently, there was no central set of procurement and contracting regulations. Every ministry, province or municipality was left to design its own ground rules, and most were seriously bad. An estimated 5% of the total Chinese government funding for contracting has been lost through corrupt or inefficient practices⁷.

In 1998, less than 20% of public projects used public bidding, and even fewer were really competitive. Construction and land use abuses made up a large percentage of all cases of corruption. Funding for public projects were caught up in a vast spider web of conflicting political and bureaucratic infighting in the complex network of intergovernmental relations. Much of the contracting was between activities owned by the government ministries themselves, or controlled though each ministry’s SOEs, and all were engaged in conniving and “gaming” both officially and under the table. There was too much power, too little supervision, and an open invitation to corruption and pathological maneuvers. And much of this corruption was very obvious to the public and a major source of distrust and suspicion. Major prime contracts could be endlessly subcontracted, and thousands of suppliers of parts, equipment and supplies were involved. There was no central set of procurement regulations; each Ministry, province or municipality made up their own, and this led to too much arbitrary, unchecked decision making authority. In the mid-90’s, there were a few huge scandals in construction projects that were so publicly visible that it forced the government’s hand. In addition, the negotiations of the Chinese government to be accepted into the GATT and the WTO system were a great stimulus for reform. The Law on Government Procurement was finally enacted in June, 2002, but the enactment of a paper law is not the same as enforcement.

New and more formal bidding processes have been mandated for all phases of contract bidding, selection and implementation. Bidding was required much more through competition, and higher standards of bidder competence were required. Bids from family, friends, or known associates of public officials were forbidden. Public officials were made responsible for any failures or corrupt practices – at all levels of activity down to that of suppliers – and for life! That is, even years later, if some failure occurred through any pathological cause, officials remained liable, even if they were no longer responsible.

The use of a single enterprise for all phases of major projects has largely been eliminated and projects are being broken out into several packages so that each can be competed separately.

⁷ Pei, *op. cit.* also Yang, *ibid.* Chapter 3

The very loose and often scandalous use of subcontracts has now been brought under control and official oversight and auditing has been extended to them. Inspection offices were mandated at local government levels and special tendering organizations have been created in most of the jurisdictions judged to have the worst problems. Also, there has been serious concern about the often incestuous and corrupt relationships between government officials and SOEs under their authority. Too many contracts had been going to “friendly” SOEs in the same political jurisdiction. As a result, there has been a forced divestiture of SOEs in the construction industry out of the hands of government agencies that were letting contracts, and the State Economic and Trade Commission has adopted the Ministry of Finance procedures and applied them to SOEs. Also, the construction markets were “nationalized”; that is, bids were opened up to bidders outside of the contracting jurisdiction – this was a means to defeat this regional/local incest.⁸

Almost all land in China continues to be owned by the government at all levels. A pattern of pathology was readily apparent: favoritism, nepotism, subsidy, bribery, opaqueness, etc. The national government had several elements that were involved in land use policy and oversight, including the Ministry of Land Resources, the State Development and Reform Commission, the Ministry of Supervision, and the National Audit Office. As with the approach to reform of contracting, these agencies combined in 1999 to 2001 to form hundreds of special joint task forces to investigate land use abuses. They uncovered more than 700,000 cases of abuse (in other words, everybody!) And as with contracting, the fundamental basis for reform was established in a new Law of Land Management. Major reforms include the investigation teams mentioned above, a mandated shift from arbitrary administrative decisions to wider use of public tendering and formal bidding processes for the use of land, and the installation of a public auction process for many large land development projects. Some of the results of the investigation teams were converted into a wave of high visibility prosecutions, including top officials such as provincial governors, head of land allocation agencies, and even Communist Party officials. Investigators also determined that some of the authorized uses of public land were illegal. These were terminated or re-competed, and land use laws are being modified. It was also found that, in addition to corrupt practices, many expensive licenses, approvals and waivers had been established, solely for the purpose of raising revenue for local governments or as leverage for soliciting bribes or kickbacks.

This whole system of reform has subsequently been extended to mineral rights exploration, extraction, transfers of mining interests, export licenses, and other allocations of public goods.

Results in the central government under the new systems are very impressive. In 1998, cases of various corrupt practices resulted in 3.1 billion yuan recoveries. By 2000, this figure was 65.3 billion, and by 2001, it rose to over 150 billion. While these numbers show “accomplishment”, they also show how enormously wide-spread and sloppy the whole field of contracting had been.

In total, it is estimated that about 10-11% of allocated funds were saved. 73% of major procurements are now under some form of central control, and this was during a period when

⁸ Yang, *ibid.* Chapter 6

total procurement volume rose more than 50%. However, thousands of smaller procurements at all levels of government have yet to be effectively reached.

Regulatory Reforms

Throughout the world there has been an upsurge of government regulation – both legitimate and not. The main emphasis has been to create or rewrite a body of regulations that enable the functioning of a market based economy, and facilitates rather than opposes the operation of private enterprises. Another purpose is to abandon pre-approvals of thousands of activities and shift to an “as needed” enforcement after the fact of new and more explicit regulations. But each new arena of regulation (e. g. environmental issues) seems magically to result in more power to the government. This is in part an exercise of the “regulatory mind” at work, but mostly it is an older traditional reliance on regulation as the means to enforce the will of the government. When combined with “vertical administration” it gives each level of government powerful tools to control and interfere with the activities of subordinate governments and all forms of enterprises. Vertical administration means that the lower level of government reports to, and is supervised by the next higher level – villages to townships, townships to counties, counties to provinces, and provinces to the central national government. It all sounds so bureaucratic and innocuous that few recognize its power as a control mechanism. So, the rhetoric promises decentralization, but the reality is sustained control of whatever is critical to the government, and the list grows every decade.

The Chinese Constitution was amended in 1999 to emphasize the rule of law. It was amended again in 2004 to provide explicit language to define and protect private property rights. This preoccupation with economic development had meant that many health and safety regulations have been neglected but the SARS scare and the huge public disgust that it engendered has pressured the CCP to now put together a new concentration on health and safety regulation.

In recent years, the CCP has announced what it purported to be a major change in their philosophy of governance: a shift away from total top down “totalistic administration” (i. e. control) to a new philosophy of the “rule of minimalism.” Yet all proposed laws or amendments are still tightly controlled within the apparatus of the CCP. The Administrative Licensing Law mandated a requirement that any regulation or administrative procedure must have a basis in enacted law. The new legal constraints on the exercise of government power often still remain to be adequately applied, in large part because of the extreme gap between the hopeful language of the new laws, and the practical resistance of officials who face a loss of power. Nor is there adequate oversight being exercised. Despite some well publicized cases, few officials have been removed or reprimanded. Few officials have any strong urge to adhere to the legal base, and judges and prosecutors are too few and poorly trained. Although the CCP likes to advance itself as the “heroes” of a reform movement, it now lacks the drive and leverage to impose the new rules on 725,851 local units of government.

However, legal restraints on the arbitrary exercise of government power often remain weak in practice, and there is a serious shortage of officials to enforce them. Legislatures have little real power and are often packed with CCP loyalists. A long history of legislative drafting in

the back rooms of the CCP restricts the idea that openness is possible. Access to the inner circles of policy formulation is often available only to special interests with good contacts in the Party of the ministries, and not to the general public. Courts lack jurisdiction and appear to have been kept deliberately weak with poorly trained judges and lawyers, corruption, a low level of legal consciousness among government officials and the citizens. There are few reported examples of any law or regulation having ever been overturned. In short, the separation of powers as understood in the West is simply not accepted.

There have indeed been drastic reductions in the total number of approvals, through efforts led by a newly created Administrative Approval Systems Reform Office, reporting directly to the State Council. In its review of 65 central government ministries and other bodies, it abolished 1,795 approval requirements – almost half of the total of more than 4,000⁹. It often turned out that, when the work of government units was more closely evaluated, it was found that many units and most of their regulations were useless and were eliminated. There seems to be some greater willingness by agencies to publish advanced notices of rulemaking, but that willingness is still spotty and not mandated.

Many of these abolitions have been of major importance. Almost all rationing and price regulations have been eliminated as vestiges of the old discredited socialist control philosophy. The whole arena of imports and exports has been modernized to facilitate economic development. Hundreds of local government regulations have been terminated where their only justification was to collect a fee. Other examples of activities no longer requiring central approval include urban infrastructure construction projects; agriculture, forestry and water reservation projects not using central government funds; real estate development and construction, and “social projects” at the local government level.

By 2003, new laws had largely limited regulations are administrative procedures to the following:

- a. Activities directly concerning national security, public safety, macroeconomic control, environmental protection and health and safety of lives and properties.
- b. Natural resources controls, allocation of public resources, and market entry in certain industrial sectors that significantly impact “the public interest”.
- c. Professions that provide service to the general public.
- d. Equipment, utilities and products involved in the above.
- e. Validation of the qualifications of entities (e. g. proposed stock issues).
- f. Any other activity where the law requires some approval.

Only the NPC, the State Council and local People’s Congresses have the right to determine whether an approval is required.. Approvals not in line with these rules were automatically abolished as of July 1, 2004. While the Constitution provides for citizen rights to

⁹ OECD Report, op. cit., p.29

criticize the government, in reality, they are not allowed to challenge acts or decisions with general applicability.

Civil Service Reforms

Every government entity was guilty of excessive growth and heavy staff redundancy, and millions of people did not have real jobs and wouldn't know how to do them if they did. Almost any government official could create a bureau, an SOE or a PSU, many of which were foolish, wasteful or unwarranted. Jobs were justified either through socialist zeal for control or as a sort of unemployment program. As a result, after fumbling for years, the central government finally initiated a serious program of reform in 1998 which was based largely on rationalization, removal of unauthorized units and personnel, elimination of duplication and overlap, and elimination of highly wasteful processes and procedures. This program extended as well to PSU and even the CCP's own offices.¹⁰ By 2002, this rationalization program had trimmed authorized staff size in all government and government-sponsored mass organizations by 1.15 million including 890,000 in municipal, county and township levels. In addition, local government at the municipal, county and township levels also laid off 430,000 employees not on the authorized staff list. Then of course, since many government units are doing the same things with far fewer employees, their managers are bragging about how they have greatly enhanced productivity!

The CCP continues to have its own political structure paralleling the official governments at all levels down to the 679,000 villages¹¹, and it continues to appoint or approve almost every senior public official at all levels. In some cases however, civil service reform has led to a loosening of political intervention (including patronage) at second and third levels. Another element of reform has been the almost unique policy of mandatory rotation of senior and some middle level officials (30% a year in some cases, with a target of 95% rotation within 5 years) from one province or township to another. The official stated purpose of these forced rotations is to reduce the likelihood of embedded corruption, but it is recognized that another purpose is to break up strong local and regional power bases. The unsavory record of governments has bred greater public awareness and resentment, and local CCP political overseers have had to upgrade their own involvement.

There are many other forms of civil service reform that parallel those found in other countries. All positions must now be authorized, with job descriptions and definitions of required skills or experience. A growing number of such positions now require taking a competitive and/or competency examination to qualify for application. Position vacancies must now be published, and usually applicants must be solicited from outside of the organization to avoid favoritism and bureaucratic incest. This became critically important following the mandatory downsizing and restructuring because there had been thousands of situations where existing employees had to compete with each other for a limited number of remaining jobs, especially at the middle and upper management levels. This had led to an ugly upsurge of bribery and kickbacks. The evaluation of employee performance is still infrequent and rudimentary, and the evaluation of organizations against their own objectives is still very risky

¹⁰ Yang, *op. cit.* pp, 25-64

¹¹ Tsai, Lilly L., "Accountability Without Democracy", p. 29. See also OECD Report *op. cit.*

because negative evaluation might be interpreted as illegal criticism of the government. Salaries and wages are still relatively low, although they have been raised a great deal in the last few years. In some cases, there remain such hidden values as provided housing, tax reliefs, or furnished autos. Salary improvements have not seemed to stem the zest for corrupt income. Nevertheless, China has made major improvements in “Civil Service” reform in the last 4 years.

Local Government Reform

General administrative expenditure as a percentage of total government budgets rose from about 5% in the 1970’s to 15% in the 1990’s. This is still very low, and it shows what has been the almost total neglect of local governance. Even the 5% was largely wasted on huge staffs of uneducated poorly trained workers, and the increase to 15%, is wholly inadequate to catch up with past neglect of social services needs, much less to deal with rapidly rising costs, unfunded mandates from the central government or the provision of badly needed new services.

When the central government fobbed off many of its loss-making SOEs onto local governments, they had little choice but to use public funds to upgrade these enterprises and try to make them profitable. To an amazing extent, they have succeeded. Many SOEs are wholly owned by the government. In addition, land ownership and leasing plus use of public funds for development makes local political leaders “quasi-owners” of many more. Local governments are, of necessity preoccupied with their own problems, could care less about Beijing, and are very defensive and “status quo” about reforms pushed from the center. Regionalism is important. Provinces/municipalities band together, often against the central government. Much of the political power is still very arbitrary and self serving as opposed to a “public service” orientation.

The People’s Armed Police is a relatively new national police, controlled by the PLA, but in part financed by local governments. It is an outgrowth of two things: the need to trim down the PLA, and the fears generated about civil unrest after Tiananmen Square. Thus, the justice system features powerful central military and police forces while regular police at the local level are weak, understaffed, lacking in authority, and frequently corrupt. They are often drawn into connivance with local corrupt politicians. The weak courts are much the same.

Land ownership continues to be a powerful tool – for revenue, for legitimate control of growth patterns, for leverage on people and organizations, and as a source of corruption.

The collapse of central planning was highly desirable and is not being missed, but it did create a vacuum. The result was dis-aggregation to local governments. While desirable, it frightens the central government, and there are many kinds of efforts under way to regain control at the center through administrative means.

As with the Soviet Union, decentralization/devolution shifted many public services from SOEs to local governments. As local governments inherited “loser” SOEs, they had to strip out the social services and create stronger government entities to manage them, and find funds to upgrade and modernize the SOEs as producer enterprises.

The Chinese Government: Central Control vs. Decentralization

Many of the SOEs were undermined because political attention was concentrated on them as producers, and nobody understood the markets which they were supposed to serve. SOEs had an inadequate understanding of what consumers wanted, nor were they willing to make an effort to meet those needs even if they understood. Manufacturers who got bonuses for maximizing production soon found that they were filling up warehouses with products that could not be sold. There was a similar arrogance about the use of price controls, which were almost universally recognized as dumb policy. It took the Chinese well into the mid-1990s to learn this lesson. As they eliminated price controls and other subsidies to SOEs, they then began to realize how excessively weak they were, and how unprepared they were to face international competition.

Thus, a program of divestiture of SOEs became absolutely critical, despite the prospects of a serious surge of unemployment, and considerable loss of “face” for the CCP. At the beginning of the divestiture program, the central government owned about 4700 SOEs and local governments about 83,000.¹² At present, the national government retains direct ownership of fewer than 1,000 SOEs with a far larger number now owned or controlled by local governments. Control is achieved by the retention of strong equity positions in thousands of others which can be sufficient to provide effective control. In addition, the State has many tools to exercise de facto control over any enterprise if it chooses to do so. These forms of control include numerous regulations, control of bank loans, or cancellation of land leasing contracts. In addition, the 190 retained SOEs tend to act like central holding companies which have hundreds of subordinate SOEs or contractors under their control.

Divestiture does not necessarily mean privatization. Many of the SOEs that have been retained tend to be the largest and most powerful enterprises that are at the heart of the Chinese economy such as steel, gas and oil, energy production, communications, transportation, and banking. Many of these enterprises have been restructured and rationalized to make them more competitive in the international market place. In other cases, SOEs have been retained but have been deliberately partnered with some private sector company which can bring money, technology and/or management skills to the partnership. In still other cases, the principle divestiture technique has been to force some form of “mergers and acquisitions” which can streamline whole industries that have been characterized by too many small inefficient units. For example, there were more than 30,000 small coal mines throughout China, and these are either being closed down or combined into perhaps 200 remaining enterprises.

The problems surrounding Public Service Units (PSU) rest more directly on finance. PSU are a separate range of institutions serving public purposes, and they are separate and distinct from either SOEs or from standard bureaucracies. Generally they provide social services while SOEs provide economic operations. Today there are more than 1.3 million PSU employing more than 25 million people, or one third of the people working in the “public sector”.¹³ Almost all function largely with public money and under standard civil service rules and regulations. Many of them were created haphazardly, with vague or nonexistent rules. They are supervised and largely financed by some government agency, but their costs –and responsibilities – have been skyrocketing, and total financing available to PSU now accounts for two thirds of total government spending. PSU thus play a role in China which seems to be a

¹² Yang, *op. cit.* pp.31-53

¹³ *Ibid.*

combination of both public and private sector roles in the U. S. The main thrust of PSU reform has been to push them to find sources of funding other than public tax funds, and a good deal of progress has been achieved; 20% of them are now self sustaining, and overall, perhaps 50% of their total funding is coming from other than official budgets, mostly in the form of charges for services.

It seems clear that the Chinese government is content with slowly loosening the relationships between the PSU and the government. In some cases, PSU have been “commercialized”, although, in typical fashion, government agencies would like to retain policy control of some PSU without having to finance them.

The CCP is gaining a lot of recognition for their success in selling off these SOEs, and yet in thousands of cases the government retains a strong equity position and seeks to use this to control the enterprise. Many foreign investors are not enthusiastic about investing in SOEs in which the government – and the Party – have every intention of exercising control and practicing political manipulation. Finally, there have indeed been many thousands of genuine sell-offs, either to other Chinese enterprises or to foreign investors, and other thousands of enterprises have simply been terminated. As a result of the exercise of these options, the government has done its best to retain employment, but it is estimated that perhaps 35 million workers have been displaced, either because their enterprise has been eliminated, or because they proved to be redundant, and thus a real threat to the efficiency of the remaining enterprises.

Budget/Finance Reforms

The extraordinary wild, chaotic, misguided and mismanaged governments of China were perfectly reflected in the financial systems that prevailed for the collection, allocation and spending of public money. Any level of government, and indeed many departments and bureaus were essentially free to invent their own financial controls and many were bizarre and incompetent. To begin with, the initial dominant Communist philosophy was that the government was the dictatorship of the proletariat, planned and run from the center, and driven by communist dialectic of mass struggle and absolute centrist control. Concepts such as managerial efficiency or delegation of authority were suspect and totally abandoned. Excessive control was exercised under the State Plan, which was both a bureaucratic nightmare and the victim of the classic political motives of under funding, misallocation of funds, and centrist lack of comprehension of reality. The State Plan was totally misdirected in terms of its long term objectives, and was ineffective in the short term as a budget planning system. By the mid 80s it was clear that it had to be abandoned.

The tax system was also completely chaotic. It overtaxed some elements of society and ignored others. It was underpowered and could not generate adequate total revenues. Neither the tax structure nor the budget allocation policy were capable of shifting revenues from stronger to weaker economic areas. Local governments were kept deprived of real local taxing power and had virtually no discretion over tax bases, rates of taxation or revenue targeting. Nor did governments develop really effective means of collecting taxes, especially from non-government organizations. Local tax rules were easily “interpreted” to favor friends and punish opponents. Few governments had any real capability to estimate revenues accurately and this produced

The Chinese Government: Central Control vs. Decentralization

many short-fall panics, chaotic reprogramming from year to year, and a persistent shortage of revenue even for the most critical of public purposes. Local officials were often guilty of inventing illegal taxes along with various fees and licenses to scrape up revenue wherever possible.

While the allocation of scarce resources is always difficult and contentious, it seems clear now that there were serious misallocations at every government level. Public spending was far too low a percentage of GDP. Too much was spent on the military and on the huge greatly overstaffed bureaucracy. Even in the 1970's, and continuing until today, there has been an overwhelming dominance of all forms of economic development, which seemed always to win out over demands for social services and public infrastructure. Threats to the environment multiplied and became more serious, but were deliberately neglected. Education, health and welfare and retirement benefits still remain seriously inadequate.

For many years, local units of government handled their financial transactions simply by creating one or more bank accounts with state owned banks. More than 107,000 such ministry accounts were created, each controlled by one or two public officials and almost totally exempt from any further outside scrutiny. Only the controlling officials had any idea what funds went into these accounts, and even worse, what came out. In many cases, withdrawals were made without any form of expenditure certification. In fact almost no government unit had any proper accounting system, nor were there any proper forms of budget formulation, allocation or expenditure control.

One of the fundamental changes in governance that precipitated major budgetary changes was the gradual abandonment of the structure of State Owned Enterprises (SOEs). The widespread pattern of SOE failure, and the need to prop many of them up with extensive government subsidies was a serious drain on the public budget, and this congenital failure did much to persuade national leadership that their economic shortcomings could never be solved with their existing centrist state socialist economy. The central government began to dump many of the smaller of these deficit SOEs on local governments at all levels for the obvious purpose of cutting the losses of the central government. This meant the acquisition of a huge "unfunded mandate" to keep these SOEs afloat, or to get rid of them in some way. In addition, many of these SOEs had been the designated provider of social services for their employees, such as elementary and secondary schooling, health clinics, retirement benefits, and aid to the poor. It became necessary therefore for local governments to detach these social services from the SOEs and link them to normally provided social services agencies. This transition resulted in many cases in major reductions in social services. A high level of education and health care costs had to be provided by private expenditure. Associated government organizations such as universities or hospitals have been desperate for funds and are trying everything now to raise money. In fact, where the government claims it has increased spending on social programs, much of it has been various kinds of off-budget revenue amounting to about 5% of GDP. During the early period between 1978 and 1995, central government revenues fell from 35% of GDP to just 11%. Recovery from this level has been achieved by a new system of having revenues collected at the local level, with a fixed sum for each jurisdiction transmitted to the central government, and the locals keeping any excess.

All of this chaos for so many years created major local government debts to banks which may or may not ever be repaid. There are huge unfunded liabilities such as pensions, road repairs or environmental dangers that are simply ignored. These obligations may run as much as 20-30% of GDP. Political interference has created vastly overpopulated government staffs, with as much as 40% of the staff redundant and without real use. A lot of money is lost through “tax expenditures” both legal and illegal, favoritism in the tax system, and corruption on so vast a scale that it seems almost improper to be honest. Contracts, revolving funds, land leases, rentals of public property, inspections, licenses, are all victims of corruption.

At the national government level, both a Bureau of Anti-Corruption and Bribery and a National Audit Office have been created. The Ministry of Finance has been given general responsibility for development of a broad ranging program of finance and budgeting reform. These organization’s roles are fairly new, with limited and ill trained staffs, facing mountains of problems.

Broad measures to reform public finance started with the abandonment of the State Plan, both as a strategic document and as the basis for short term budget planning. In its place is a new and more modern budget formulation/execution system has been established, generally supervised by the Ministry of Finance including a general oversight role over both the content and processes for budget formulation and financial control. The divestiture of SOEs has largely been accomplished, and social services extracted and folded into local government programs. Remarkably, many of the “loser” SOEs have in fact been revitalized by local governments. Mayors, and county executives and provincial governors have become capitalists and have used public tax funds to upgrade these SOEs, often by luring foreign investors to joint venture with them. As a consequence the incomes from these enterprises and the taxes they now pay have become very welcome sources of local government revenue. Policies have been initiated to cure imbalances in resource allocation. No governments seem to have lost their zeal for economic development investment, but most have learned that they cannot politically continue to ignore growing citizen pressure for more adequate social services and public infrastructure. Most of the heavy burden of taxes traditionally leveled on farmers was lifted at last in 2005.

Local governments are now under a form of contract with the central government where they collect the taxes, forward an agreed upon sum to the national government, and are permitted to keep any surplus. Of course, this “revenue sharing fund” is used by the central government to keep a grip on local governments by adjusting the amounts to be forwarded and making sure that local governments do not become financially too independent.

Massive reforms have been largely achieved in accounting systems, budget formulation practices, and budget review and analysis. Serious efforts are still under way to capture all revenues and expenditures of all government levels into a formal consolidated budget. “Reserves for contingencies” were eliminated because they had turned out to be slush funds vulnerable to misallocation and corruption. Almost all of the 107,000 risky local bank accounts have been replaced by a centralized fiscal processing system run by the Treasury. Budgets are now prepared in the form of comprehensive organizational accounts and not just by functions such as personnel or travel. A form of zero based budgeting has been introduced, and far greater detail is being included in budget submissions. This system includes pre-approvals of fund disbursements, and post-expenditure reconciliation between expenditure approvals and actual

The Chinese Government: Central Control vs. Decentralization

disbursements. In the process, it was found that there were thousands of illicit “loans” between banks and public officials that added greatly to the size of public debt. Special anti-corruption measures are being pursued to clean up this mess as part of a broader effort to eliminate unauthorized programs, redundant and unauthorized staffing, “ghost” contracts, unsupported payments, and unauthorized offices. As a part of this reform effort, it was found that financial transactions on most major public works projects (such as the Three Gorges Dams) were so blatantly corrupt that the Ministry of Finance had to take them over and start making direct payments, bypassing the supervisory bureaucracies. This has led to a far more serious attitude about the use of competitive contracting for most government procurements.

In sum, the Chinese government has taken the former financial chaos seriously, and has generally made impressive improvements in almost every facet of financial management. But this more disciplined and fact based control has also revealed that the government has incurred a huge backlog of contingent liabilities – equal perhaps to as much as 20% of GDP. Nobody knows exactly what they are, how much they amount to, or how they are going to be funded – if at all.

Political Reform

The one topic of reform that must be discussed with great care is political reform. It remains illegal in China to criticize the government at any level, and “criticism” is interpreted very broadly. As with the economic reforms that emerged slowly in the 1980’s, initial very guarded notions of political reform are being discussed within the CCP itself. In general, the two main schools of thought are those who favor absolutely no retreat from current practices and those who favor some “democratization” but only within the party itself and not in the country. But the common and compelling attitude in both schools is that, whatever may be done, it cannot be allowed to weaken the political control of the CCP. Thus, those reforms that have been undertaken to date must be assessed in this light. Many reforms are in fact designed to appear to be “democratic” outside of the Party, but in reality are subtle ways to further enhance control. If there are sweeping cuts in the party bureaucracy and some top to bottom rationalization of lines of Party authority, the net result appears to be that more power than ever has ascended to the top. If there is now some competition for election to top party posts, it is still a small elite group that nominates the candidates. The inner-Party democratization movement announces the birth of “accountability” by allowing occasional votes on issues in Party meetings, and the publication of more formalized Party procedures. Many Party organs at all government levels are now expected to publish some form of annual report, but they tend to be bland and self-protective. Local Party congresses are being urged to meet on some regular schedule instead of a pro forma “once each five years” which is the current norm.

It is true that there are now many elections at the village level, but this seems to be a classic example of how the CCP still thinks. Village committees are usually informal arrangements with little official power. Elections to these committees has conveyed the impression of growing democracy, but it appears that the real power remains where it has always been – with the local CCP offices at the provincial, county, township and village level. Candidates for village councils must be approved by the local CCP office, and in fact, many of the nominations originate there. In many cases, the election is really to choose 1-2

“recommended” candidates and the local Party chief still gets to make the selection. Thus, the appearance of democracy is achieved without any sacrifice of absolute control.¹⁴

Further, there is a growing willingness to allow the creation of civic organizations ranging all the way from unions, to parent/teacher organizations, professional associations, or “cause” groups such as environmentalists or women’s rights groups. But all of these groups must be authorized by the CCP, their plans carefully reviewed, and their activities monitored by some designated government department “sponsor”. At many of their meetings, there will be a ministry representative and a CCP representative present. These groups have some latitude to criticize local affairs, but any criticism of the activities of the national government, or any attempt to organize opposition to any national government policy or action remains illegal and highly risky.

Conclusions

Decentralization really involves four different types of actions: **decentralization**, which means the performance of national government programs at the local government level under their own authority; **delegation**, which means the assignment of central government authority either to local units of government ministries or more importantly the delegation of central government responsibilities to local governments which must act under central government control; **devolution**, which means the transfer of some responsibility out of the government into private hands; and **divestiture** which is a massive government program to divest itself of thousands of state owned enterprises by many means including elimination, consolidation, privatization, or transfer to local governments.

Decentralization has become the official policy for many types of government responsibilities, but it is carefully limited to local program service delivery, and for purely local programs of economic development. These local activities must be performed within broad policies set by the national government, and under intense oversight. These activities are predominantly funded from local income including business operations run by local governments, often based on locally managed SOEs, but also increasingly on non-government activities. Thus, it seems very apparent that the national government is pursuing a policy of “decentralization of operations, centralization of policy”, and it has not changed its commitment to centrist control, both political and economic. It has however become more sophisticated about how that control is exercised.

The decentralization elements of the reform movement are tightly linked to a collateral policy of central government hardening of the instruments of such central control – the tax system, approval of budgets and resource allocations, the elaboration of new and more stringent laws which magically enhance central authority, and the widening range of government regulations, most of which strengthen the authority of central regulatory agencies. The government has placed great stress on the value of “vertical administration” in which each

¹⁴ Thornton, John “Long Time Coming: The Prospect for Democracy in China”, *Foreign Affairs* Jan/Feb. 2008; Shambaugh, David, “China’s Communist Party: Atrophy and Adaptation”, 2008. Tsai, Lilly L., *op. cit.* Chapter 2.

The Chinese Government: Central Control vs. Decentralization

agency or program of government must report upward through every level of government is the ultimate authorities in Beijing.

Delegation of authority or responsibility then, if viewed in this light, is recognized as more theoretical than real. In fact, delegation is in many ways a serious problem. For example, local governments have been “delegated” responsibility to provide local logistical support to the regional commands of the People’s Liberation Army. This is a heavy financial burden which the local governments should not have to bear. Similarly, the central government has attempted to delegate responsibility for the enormous problems of environmental hazards, with pitifully inadequate funding provided. The national government may now openly criticize local governments for not having solved 60 years of total environmental neglect.

The whole idea of devolution seems essentially unacceptable. CCP leadership still wants to constrain the growth of the private sector, because it still has heavy commitments to major SOEs and wants to keep as much of the economy in SOE hands which the CCP can more effectively control. However, some public service units are being allowed to escape from the government if they can substitute other financial sources for government subsidies.

Perhaps the most successful “D” has been the divestiture of state owned enterprises. It has taken great courage and resourcefulness to abandon more than 50 years of commitment to this form of organization. Not only has there been the trauma of confronting the management of thousands of SOEs, and the downsizing of millions of workers, but the dramatic shift in policy to a market based economy threatened the very rationale of state socialism, and the philosophical underpinnings of the CCP itself. The government seems to be emerging from these problems in full control for the very reason that this economic conversion has worked so spectacularly, and most Chinese are happy with their new world. It is ironic that there seem to be very few communists left in the CCP, probably fewer than on Ivy League faculties but perhaps they feel that the name has ceased to have much meaning as long as the control remains.

But the real answer as to the intent of the government lies in two perceptions, one political and the other managerial. Politically whenever the Party has concluded that it had to tolerate some change, it has studied the optional ways in which that change could be undertaken, and it appears always to have selected the option that results in the least possible loss of centrist power. For example, in the SOE divestiture program, the government never really contemplated the full abolition of SOEs. Instead it worked its way carefully through the options for SOE divestiture on a case-by-case basis, industry by industry looking for the “least retreat” choice. It kept all of the really powerful “commanding heights” enterprises, and carefully handed off small and medium size enterprise “losers” to provinces or municipalities. Others were “corporatized” with government retention of a heavy equity interest, or “rationalized” through consolidations and mergers. Others were privatized, have their subsidies withdrawn, or were simply eliminated.

Reforms of management systems and procedures were deliberately undertaken so that they culminated in a tightening of centrist authority. The whole concept of vertical administration is best understood not as improved management, which it is, but as “strengthened control at the top”. This control was exercised through program channels such as transportation which had to report to central government ministries. At the same time, local administrative

officers such as human resources management directors, budget officers or auditors had their own upward channels to controllers in Beijing.

The growth of the powers of public regulation, and the passage of under girding laws also has meant that the range of government authority has been substantially expanded and deepened, and the power to enforce has been strengthened and made more legitimate. It has been possible for governments at all levels to eliminate millions of clearances and pre-approvals (e.g. approval of marriage licenses) in favor of inspections “as needed” after the fact. This regulatory authority usually now includes powerful authority to investigate, interrogate and seize records.

Finally, the CCP has not relinquished its power to control the appointment of public officials at all levels down through townships. This is a party authority and it usurps the normal authority of government ministry line managers. No top official gets appointed, promoted, transferred or trained without CCP instigation or approval. Even in the new environment of contested elections at the village level, it would be rare even to nominate candidates without the approval of the local CCP office. If one asks “what is the purpose of having 3.6 million CCP organizations in the country?” the answer is that, for good or ill, they exist to deploy the power and authority of the Party, and to enforce its will. Corruption has been called “the kudzu” of China. The CCP has attempted to portray itself as the “heroes” who are going to do away with it, but the Party and the government control so many things, and retain so much control that a large number of the corrupt officials are “them.” Anti-corruption drives range from sincere to sham, and a few arrests of senior officials represent political maneuver rather than real purging.