

BTI 2008 | China Country Report

Status Index	1-10	4.70	# 85 of 125	
Democracy	1-10	3.15	# 112 of 125	➔
Market Economy	1-10	6.25	# 51 of 125	➔
Management Index	1-10	4.86	# 68 of 125	

scale: 1 (lowest) to 10 (highest) score rank trend

This report is part of the Bertelsmann Transformation Index (BTI) 2008. The BTI is a global ranking of transition processes in which the state of democracy and market economic systems as well as the quality of political management in 125 transformation and developing countries are evaluated.

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Key Indicators

Population	mn.	1,304.5	HDI	0.77	GDP p.c.	\$	6,012
Pop. growth ¹	% p.a.	0.6	HDI rank of 177	81	Gini Index		46.9
Life expectancy	years	72	UN Education Index	0.84	Poverty ³	%	34.9
Urban population	%	40.4	Gender equality ²	-	Aid per capita	\$	1.4

Sources: UNDP, Human Development Report 2006 | The World Bank, World Development Indicators 2007 | OECD Development Assistance Committee 2006. Footnotes: (1) Average annual growth rate 1990-2005. (2) Gender Empowerment Measure (GEM). (3) Percentage of population living on less than \$2 a day.

Executive Summary

Within business circles, China's overall economic and political development is assessed very optimistically. However, assessed according to BTI criteria, China's performance is more ambivalent. For one, during the period of observation, the transformation process progressed further; GDP growth increased and the HDI value also improved. WTO membership and the strengthening of economic ties with ASEAN as well as with India and other neighbors intensified the international economic integration of the PRC. But some substantial problems remain unresolved. The most pressing among these are reforms to the financial sector, rising social inequality and the resulting increase in popular unrest, increasing regional developmental disparities, corruption, environmental degradation, and stagnation or even deterioration of human and political rights. Although the new leadership around President Hu has recognized the gravity of these problems, central government political blueprints – most prominently the plan to establish a “harmonious socialist society” – aimed at resolving them are still contested and their implementation often thwarted by local level officials. However, if these challenges are not addressed quickly and properly, they will constitute a severe burden to further economic development as well as to the Chinese leadership's legitimacy – and thus to its steering capability. Concerning human rights and political reforms, the “fourth generation” political leadership in China also rules out transformation toward liberal democracy. Moreover, as popular discontent and disturbances have grown considerably, the political leadership resorts more frequently to repressing critics, political activists and the media. Quite to the disappointment of the international community, this means that human rights and political freedom have not improved under the leadership of President Hu. On the whole, transformation in China remains limited to the economic sphere. Improvements are matched by severe transformation deficiencies. Therefore, transformation remains unstable and is imperiled by economic shocks and/or political shake-ups.

History and Characteristics of Transformation

The “Opening and Reform Policy” initiated economic transformation in 1978. After the upheaval of the Cultural Revolution, the Chinese leadership emphasized economic and political consolidation. Despite initial structural deficiencies, economic reforms benefited from preconditions seldom found in developing countries; the large size of the rural workforce facilitated the recruitment of cheap labor for the emerging industrial sector, and, despite the existence of a planned economy, the public sector remained rather limited. These specific circumstances considerably facilitated economic development.

Consensus within the Chinese leadership to be resolute in following the Opening and Reform policy facilitated reforms. However, the leadership also agreed upon limiting the reforms strictly to the economic area; political reforms and liberalization were rejected.

Economic reforms proceeded gradually and experimentally. Working without a detailed roadmap, the Chinese leadership allowed for reform initiatives from lower administrative levels to be implemented locally on a trial basis. Successful initiatives were adopted as national policies. The introduction of the “household responsibility system” in agriculture is one prominent example. Its implementation in rural areas resulted in rapid increases in income and industrialization in these areas. This experimental policy thus served as a model for national agricultural reforms.

Economic reforms proceeded in a highly decentralized manner and allowed for gradual changes, avoiding the transformation shocks that have been observed in the Russian Federation. Most important for the maintenance of economic stability was the Chinese leadership’s decision to allow for the coexistence of a planned economy and the gradually emerging private sector. During the reform process, the de facto economic importance as well as the political appreciation of the private sector increased steadily. In March 2004, the latest revision to the Chinese Constitution protects private property and acknowledges the importance of the private sector in the national economy. Economic reforms were accompanied by yearly growth rates of about 8.4% (1975 – 2004) and relatively low levels of inflation. Consequently, living standards improved significantly; the number of the absolute poor decreased from 250 million (1978) to 26.1 million (2005).

This overall success is obscured by the increasingly uneven spread of wealth. The income gap is widening with the richest 10% of households accounting for over 40% of the nation’s wealth and the poorest 10% only for 2%; the per capita GDP of the country’s wealthiest province is more than 10 times that of the poorest province.

Rampant corruption, an inefficient legal system, government agencies unable to properly implement laws and regulations in accordance with WTO requirements, and a lack of sustainability in economic development constitute other serious problems. Environmental degradation will result in particularly enormous future economic and social costs and thus burden further development. Inadequate social security, health care and pension systems also give rise to concern. China is increasingly unable to fulfill the demands of the growing middle class for education, suitable employment opportunities and political pluralism. All of this results in a continuing erosion of the legitimacy of the ruling Chinese Communist Party (CCP) and a dramatic increase in social unrest as people without access to institutionalized channels for criticism resort to riots and violent clashes with authorities in order to air their grievances.

Thus, the current leadership, headed by President Hu Jintao, who has been in office since March 2003, can no longer concentrate exclusively on economic growth but must also take into consideration the negative social consequences of economic development. Therefore, President Hu has made building a “harmonious socialist society” and sustainable development top priorities for the near future. Although the Chinese political leadership’s growing concern with social and environmental problems must be applauded, there are still no signs as to improvements in the areas of human rights, the rule of law and democratization.

Transformation Status

I. Democracy

1 | Stateness

There is certainty about the nation's existence as a state and virtually no competition with the state's monopoly on the use of force. With the important exception of Taiwan, which is regarded as a renegade province, and of continuing secessionist activities in Xinjiang and Tibet, there is basically agreement about which people qualify as Chinese citizens.

Monopoly on the use of force

According to the Chinese constitution, all citizens enjoy the same basic civil rights. Ethnic minorities are vested with certain, albeit limited, autonomy rights by the constitution.

State identity

The state is defined as a secular order; religious dogmas have no influence on politics and/or the law. Only five religions – Protestantism, Catholicism, Buddhism, Daoism, Islam – are officially recognized yet strictly supervised. With the legitimacy of the Chinese Communist Party (CCP) as well as traditional (family) values eroding during economic and social development, there is a trend for people to search for spiritual guidance. Within this spiritual vacuum, Buddhism is able to attract increasingly more people. The same is true for Confucianism. The government is benevolent regarding the revival of these forms of spiritual guidance, which to date only influence people's private lives and have no political implications.

No interference of religious dogmas

In the People's Republic of China (PRC), a fundamental and sufficiently differentiated bureaucratic structure extends throughout the entire territory. However, conflicts among different layers of the administration persist and aggravate tensions. In particular, it has become more difficult for the central government to ensure that national policies are implemented correctly by lower administrative levels.

Basic administration

2 | Political Participation

Although elections are held regularly at all levels, central-level elections fail to qualify as free and competitive. At the local level, limited venues for participation exist. Since 1998, local (i.e., township and county level) elections have been implemented nationwide. To date, deputies to local-level people's congresses as well as village chiefs are elected directly; however, in most cases they have been approved beforehand by the CCP. Moreover, vote buying and manipulation pose severe problems; therefore, election legislation is currently under review in order to include provisions which will deal with these defects.

Free and fair elections

Rulers at the central level are not democratically elected. Instead, all leading political personnel are recruited from the ranks of the CCP, which is the most important and mostly exclusive admittance to political leadership.

Effective power to govern

Although freedom of association and assembly is ensured by the constitution, the state often interferes with this right. Political organizations in competition with the CCP, such as opposition parties like the China Democratic Party, are interdicted and supporters are subject to repression. In nonpolitical (at least superficially) issue areas such as culture, environmental protection, social issues, health, and philanthropy, more and more NGOs are established at the grassroots level, mostly by citizens directly affected themselves by some specific problems. Since NGOs are required to register with the relevant state agencies, their work is strictly controlled by the government. As long as NGOs are not outspokenly critical of the regime, they are tolerated by the government as providers of beneficial services in areas where the adverse effects of economic development are affecting people's lives (environmental protection; health care/AIDS; support for the disabled, orphans, etc.), and where governmental agencies lack the funds and/or the will to provide relief themselves.

Association / assembly rights

Freedom of expression is severely limited. Most influential media are controlled and/or owned by state organs. Amid increasing social unrest, journalists covering controversial issues, criticizing the CCP or deviating from state propaganda increasingly suffer harassment. The PRC has jailed more journalists than any other country and Reporters Without Borders ranks China 159th out of 167 countries on its global press freedom index. In mid-2006, a proposal for new legislation was put forward which would allow the government to fine media outlets that run independent reports on public emergencies, further restricting press freedom. Moreover, in September 2006, the Chinese government released new restrictions on press freedom, giving the governmental Xinhua News Agency control over distribution within China of information from foreign agencies and authorizing Xinhua to censor news covering topics related to national unity or social stability. Restrictions on the Internet are also tightened as several critical

Freedom of expression

websites and chat rooms were shut down and access to foreign websites was interrupted; moreover, the email correspondence of political activists is spied on, resulting in the detention of several bloggers and cyber-dissidents. Unfortunately, foreign Internet companies have largely cooperated with the Chinese government on censorship enforcement.

3 | Rule of Law

The political system is characterized by the Leninist principle of concentration of state powers with the National People's Congress (NPC) as the highest organ of power. All state organs, the executive and the judiciary at the central level as well as at the local levels, are responsible to the NPC or local People's Congresses, respectively. Thus, the constitutional framework does not establish a system of separation of powers. Since the CCP is regarded as superior to the constitution, the NPC and local People's Congresses are subject to CCP directives and control. Therefore, a system of checks and balances, as well as subordination of the party and state powers under the law, are all nonexistent.

Separation of
powers

Although the judiciary is institutionally differentiated, there is a considerable lack of judicial independence. Judges' decisions are to be approved by the courts' CCP party committees, and since judges are appointed by local People's Congresses and paid by local governments, party as well as state organs have considerable leeway to interfere with judicial decisions. Particularly at lower level courts, judges themselves are also very susceptible to corruption. The bar also lacks independence since the All-China Lawyers Association is institutionally subordinated to the Ministry of Justice, and leading ACLA officials have close personal relations to the Ministry. Particularly in criminal and rights defense cases, lawyers are subject to a number of restrictions concerning the performance of their duties, especially in conducting investigations and gathering evidence. Moreover, lawyers lack protection against official abuse since the concept of immunity for lawyers and complementary measures that provide protection to them in the performance of their work are alien to the Chinese criminal law system. Consequently, the number of criminal defense lawyers accused of violations of the law when representing defendants has increased. Only in the area of economic adjudication are there indications of growing professional independence and reduced political influence.

Independent
judiciary

In cases of low-level corruption, officials are punished rather frequently; however, corruption cases are mainly treated by the CCP, not by the courts. At the higher and central levels, corrupt officials are often exempt from punishment; only a few "showcases" have been treated with extensive media coverage in order to substantiate the CCP and government's decidedness decision to reign in corruption. Since rampant corruption has become a major source for growing

Prosecution of
office abuse

public unrest, the success of anti-corruption measures is central to the legitimacy and, indeed, the very survival of the CCP.

The constitution guarantees certain civil rights such as freedom of speech, of the press, of assembly, of association, of demonstration, of religious belief, of person etc.; a March 2004 amendment to the constitution explicitly codified the protection of human rights. Nevertheless, interference with these rights by CCP and state organs has become increasingly frequent. For example, the authorities do not tolerate religious/spiritual groupings that challenge the CCP's claim to the monopoly of power, such as underground Protestant churches and Catholic communities loyal to the pope, and activists are frequently persecuted. Compulsory resettlement due to large-scale government construction projects or illegal land-grabs by local authorities violate people's property rights. Although there is legislation in place, such as the Administrative Litigation Law, which enables citizens to sue the government, the judiciary is no reliable safeguard against violations of human and civil rights or official misbehavior. Judges are subject to influence from local officials and the CCP, and judicial corruption is rampant; lawyers willing to support citizens against the government are systematically threatened and hampered in their work. Consequently, the number of lawyers willing to take on civil and human rights cases is steadily decreasing, which further limits citizens' already sparse opportunities to seek judicial redress for violations of their rights.

Civil rights

4 | Stability of Democratic Institutions

The formal arrangement of political institutions is defined by the supremacy of the CCP; thus, the political system of the PRC can be classified as a centralized socialist dictatorship of the ruling CCP. All leading political personnel are recruited from the ranks of the CCP. Other political organizations in competition with the CCP are prohibited and suppressed. Elections are held regularly at the central and the local level but fail to qualify as free and competitive. The judiciary is not independent; especially in sensitive cases involving public disturbances, state secrets, etc., political involvement in the judicial process and in decision-making is frequent. The prospects for future democratization are not favorable, because the CCP leadership is not prepared to share power with other political actors and constantly rules out the adoption of a Western model of pluralist democracy in the PRC.

Performance of democratic institutions

In China, at least at the central level, there are no democratic institutions as such. Democratic procedures, such as the election of heads of village committees, have been implemented on an experimental basis, but only at the local, that is, village level. These first steps are not intended to influence developments at the central level; the Chinese leadership still refuses to consider establishing a Western-style democratic, multiparty system.

Commitment to democratic institutions

5 | Political and Social Integration

The party system plays no role in forming opinions and political will. The CCP's claim to power is comprehensive; other, so-called "democratic" parties are not competitors with the CCP, but are controlled by and subordinated to the CCP. Underground opposition parties or organizations are relentlessly suppressed.

Party system

Since the late 1970s, NGOs and interests groups have proliferated and become more diversified. Today, NGOs concentrate mainly on social issues, such as environmental protection, animal welfare, representation of the interests of marginalized groups (women, the disabled, ethnic minorities, children), and also provide services for the population, such as legal aid and consumer protection. There are more than 133,000 officially registered NGOs, as well as many grassroots NGOs that are not officially registered. However, NGOs are poorly connected and lack organizational capacity and funding. Most Chinese NGOs depend on funding by foreign counterpart organizations. Foreign NGOs and international organizations such as the World Bank also support Chinese NGOs in the areas of networking and capacity-building. In 2006, the Chinese government assumed a more repressive stance towards NGOs, virtually freezing the registration of new groups and watching existing ones more closely.

Interest groups

Empirically reliable insights concerning Chinese citizens' consent to democratic norms and procedures are not available. Most citizens are apathetic about elections at the local level since deputies have little influence on policy-making, and the local People's Congresses are usually viewed as rubber stamps. In more general terms, the absence of political and cultural prerequisites, such as traditions of liberal constitutionalism and a positive record of political competition for power, constitute severe hindrances to democratic transformation.

Consent to democratic norms

At the micro-level, there is a certain degree of social self-organization and construction of social capital, especially regarding strong loyalties among family members. Locally, citizens directly affected by severe problems such as environmental degradation, local government corruption, violations of basic human rights, etc., also associate for purposes of self-help. Occasionally, these associations are supported by activist lawyers. These groups are closely watched, and since they often aggressively bring social ills and wrongs to the fore, local governments in particular try to silence them by repressing activists and leaders. On the other hand, since Chinese society increasingly favors materialistic values, charitable organizations that go beyond immediate self-help for their members are confronted with deep suspicion. Therefore, the build-up of social capital and trust through charitable organizations is not only hindered by government surveillance and regulation, but also by a lack of trust and even compassion among the broad population.

Associational activities

II. Market Economy

6 | Level of Socioeconomic Development

Economic development also resulted in severe inter-regional and urban/rural income disparities; in 2005, the disposable income for urban and rural residents amounted to 10.493 yuan and 3.255 yuan, respectively. In 2005, 85 million Chinese lived in absolute poverty. The widening income gap seriously threatens social stability by leading to increasing large-scale public disturbances, mainly in the countryside, and massive migratory movements. China's "floating population," i.e., migrants without local household registration (hukou), amounts to 147.35 million (2005). Low per capita income in rural areas and the fact that more than 60% of the workforce is employed in the agricultural sector indicates a large scope of subsistence production. Significant parts of the population are also excluded from the benefits of economic development, mainly due to poverty, gender reasons and inadequate education. In 2004, the GDI reached a value of 0.765.

Socioeconomic
barriers

Economic indicators		2002	2003	2004	2005
GDP	\$ mn.	1,453,831	1,640,962	1,931,710	2,234,297
Growth of GDP	%	9.1	10.0	10.1	10.2
Inflation (CPI)	%	-0.8	1.2	4	1.8
Unemployment	%	4.0	4.3	4.2	-
Foreign direct investment	% of GDP	3.4	2.9	2.8	3.5
Export growth	%	29.4	26.8	28.4	24.3
Import growth	%	27.5	24.8	22.5	11.4
Current account balance	\$ mn.	35422.0	45874.8	68659.2	160818.3
Public debt	\$ mn.	88,613.2	85,329.2	89,773.2	82,853.1
External debt	\$ mn.	186,132.2	208,452.2	247,701.2	281,612.1
External debt service	% of GNI	2.2	2.3	1.2	1.2

		2002	2003	2004	2005
Cash surplus or deficit	% of GDP	-2.6	-2.4	-2.1	-
Tax Revenue	% of GDP	8.5	8.5	8.9	-
Government consumption	% of GDP	15.9	15.2	14.5	14.2
Public expnd. on edu.	% of GDP	-	-	-	-
Public expnd. on health	% of GDP	1.7	1.7	1.8	-
R&D expenditure	% of GDP	1.2	1.3	1.4	-
Military expenditure	% of GDP	2.3	2.3	2.4	2.0

Sources: The World Bank, World Development Indicators 2007 | UNESCO Institute for Statistics | Stockholm International Peace Research Institute (SIPRI), Yearbook: Armaments, Disarmament and International Security

7 | Organization of the Market and Competition

Although market economy competition and the development of a market institutional framework are improving slowly, some problems remain. Freedom of pricing is not universally guaranteed; for essential goods and services, such as food and energy, prices remain controlled. Price controls mainly operate in the form of subsidies to SOEs to let them produce and sell goods at artificially low prices. The Chinese currency is not fully convertible; in July 2005, Beijing scrapped the U.S. dollar link of the yuan and established a managed floating exchange rate regime with respect to a basket of currencies. Since the central government increasingly recognizes the importance of the private sector, new legal requirements have been formulated which aim at promoting the equal treatment of the private sector with SOEs. These guidelines facilitate market access for private enterprises to industries that were previously restricted, dominated by SOEs or heavily regulated, such as public utilities, financial services and national defense. The guidelines also mandate the equal treatment of publicly and privately owned enterprises regarding capital market access. However, the implementation of legal rules is often hampered by local governments' protectionist behavior, frequently interfering with economic decision-making and favoring local government-owned firms. This results in massive over-investment in some industries (mainly steel, aluminum and cement production and property projects), haphazard investment decisions, and banks overburdened by non-performing loans. As a result of mainly locally driven over-investment, the economy still shows severe signs of overheating – in the first three quarters of 2006, GDP, property and fixed-asset investment grew by 10.7%, 27.3%, and 26.6%, respectively. As a countermeasure, the central government

Market-based
competition

repeatedly raised interest rates and lifted reserve requirements for banks. But as long as local governments are not wholeheartedly implementing the prescribed austerity measures, the influence on cooling down the economy hitherto has been limited. The informal sector – people employed by urban private enterprises, the self-employed, and rural migrant labor in informal employment – is steadily gaining ground. As laid-off employees from SOEs and low-skilled rural migrant workers have found new jobs in the informal sector, this segment becomes more important for releasing employment pressure in the labor market. The extent of the informal sector can only be estimated. From 1990 to 2004, informal employment increased by 125.55 million people, indicating an average annual rise of 12.5%; in 2004, the informal sector accounts for one-third of non-agricultural GDP.

In June 2006, the Chinese government approved the draft Anti-Monopoly Law. This is a step forward to prevent monopolies by large SOEs and foreign multinationals. The draft law comprises provisions on banning monopoly-oriented agreements, forbidding abuse of dominance in the market, and on investigations and prosecutions of monopolistic practices. SOE monopolies are mainly found in telecommunications, infrastructure, railways and aviation, and banking. However, the latest draft no longer contains provisions capable to discipline such state “administrative monopolies”; it is feared that the anti-monopoly law will be used mainly to pare back the influence of foreign firms. Anti-monopoly regulation remains fragmentary and since the draft does not contain provisions for the establishment of a single high-level anti-monopoly enforcement agency, the new law’s effect on curbing state administrative monopolies and monopoly formation in general seems to be limited.

Anti-monopoly
policy

Since accession to the WTO, foreign trade has been consistently liberalized. Direct intervention in trade decreased and import barriers have been reduced; for example, most favored nation tariffs and duty rates were reduced, import quotas and trading rights have been abolished, and import licensing procedures have been simplified. The PRC also entered into regional and bilateral free trade agreements. The abolition of export barriers is lagging behind to a certain degree; some restrictions, such as prohibitions and licensing, are still maintained. Occasionally, the Chinese government introduces ad hoc measures such as interim export taxes and VAT rebates in order to manipulate the import/export of certain goods depending on the domestic supply situation.

Liberalization of
foreign trade

In compliance with WTO requirements to open up the financial sector by the end of 2006, Chinese state-owned commercial banks (SCBs) have absorbed large amounts of foreign investments. The government has also listed major SCBs on overseas stock markets. However, since foreign investors hold only minority shares, these banks remain state-owned. Since top bank managers are appointed by the government, governmental influence over bank lending decisions is high,

Banking system

particularly at local levels. Risk management and internal controls are in their infancy. Thus, financial resources are not efficiently allocated in accordance with market economic criteria. Although the central bank spent more than \$100 billion to re-capitalize or write off bad loans, there are still non-performing loans in the banking system. Estimates as to the exact amount vary; official estimates indicate 225 billion of non-performing loans (2005), whereas international rating agencies speak of \$500-650 billion. The official debt-to-GDP ratio is 18%, whereas international estimates assume 81%. However, the China Banking Regulatory Commission seems to be serious about reducing local governmental involvement and improving accountability in the banking sector. Together with other reform measures, such as adopting provisioning and capital adequacy rules in accordance with international standards, removing the interest rate band, re-capitalizing banks, introducing administrative controls in order to reduce lending to overheated sectors, as well as preparing banks for listing, there are indications that the Chinese banking sector is progressing toward international standards, however slowly. The financial market is still dominated by commercial banks, and although institutional investors are on the rise, this segment is still in its infancy. Privatization in the financial sector is not advanced; most non-bank financial institutions such as life insurance, investment, and securities companies are state-owned or controlled by local governments.

8 | Currency and Price Stability

During the period under review, China amassed a gigantic trade surplus (\$168 billion in 2006), and rising inflation is still a problem. Official CPI figures rose around 2% yearly from 2000 to 2006; although absolute figures are rather low, the constant upward trend is worrying and volatility has been rather high. China has also accumulated \$987.9 billion (2006) in foreign currency reserves, most of them stemming from a massive trade surplus with the United States. This puts the Chinese government under pressure to revalue the yuan. However, a stronger currency would erode the earnings of many SOEs and export-oriented light manufacturers, thereby threatening jobs; consequently, the currency will only be adjusted slowly and gradually.

Anti-inflation /
forex policy

Macroeconomic stability is of utmost importance to the Chinese government. Economic growth is needed urgently for the creation of jobs; however, growth to date is not self-supporting, that is, grounded in national consumption, but relies heavily on fixed-asset investment and exports. Therefore, policymakers accepted a potentially overheating economy and only gradually introduced tightening measures since these would have hurt the aforementioned areas in particular, thereby threatening jobs. For the Chinese government, economic tilt is easier to deal with than rising unemployment and the resulting public disturbances.

Macrostability

9 | Private Property

Although, since constitutional amendments in 2004, private property rights are politically regarded as on a par with public property, Chinese citizens still cannot legally own land, but can obtain land-use rights. These are also violated frequently, especially by local governments illegally taking land from farmers for development projects without proper compensation. The same is true for forced evictions of citizens in the course of major construction projects. In March 2005, a draft version of the Private Property Law was shelved due to intra-party disputes. In August 2006, the National People's Congress (NPC) discussed a revised version of the draft Property Law that will give private property the same protection as government assets while affirming the dominant role of state industry. The debate about the draft law made it clear that the government's and party's priorities lie with protecting the dominant status of the state-owned economy while simultaneously encouraging the private sector.

Property rights

Although the importance of private enterprises for the creation of jobs and economic growth is generally accepted, they are still discriminated against, especially regarding access to capital. Business entry barriers remain, such as licensing procedures hampered by long delays and a lack of transparency, local government favoritism, as well as pressures to pay illegal fees. The transformation of SOEs into public corporations only indirectly controlled by the state continues. The adoption of the Corporate Bankruptcy Law in August 2006, which applies to private companies, financial institutions and foreign-invested companies as well as to SOEs, will support the restructuring of non-profitable SOEs as it allows them to declare a policy bankruptcy, in which laid-off workers will be paid first.

Private
enterprise

10 | Welfare Regime

Establishing a social security system is a central part of President Hu's 15-year plan of building a "harmonious socialist society." To date, social security schemes are largely urban-based; most farmers and migrant workers are not covered. In rural areas, citizens must rely on family support in cases of need; rural social security schemes have only been implemented in a few areas and on a trial basis. On the whole, the social insurance system encompasses only 10% of the population. Moreover, the existing program is plagued by a lack of resources, mismanagement of funds and corruption. This problem is especially prominent in the area of health care, where hospitals and doctors charge arbitrary fees, insist on bribes, etc., resulting in medical treatment that is increasingly unaffordable for a large part of the population.

Social safety nets

Despite reform measures aimed at bolstering the development of more remote regions, equal opportunities for citizens in all parts of China have still not been established. Access to education, social security systems and public services is only secured in urban coastal regions; the countryside and western regions, and in many cases ethnic minority regions, still lack the provision of basic supplies. This is illustrated by inequality in child health care; child mortality in urban areas is only one-third of that in rural areas. Regarding gender, political participation of women is low, particularly at the local level, due to gender-based discrimination. Women also face difficulties in promotion and are often laid off first.

Equal opportunity

11 | Economic Performance

The Chinese economy still maintains very high annual average growth rates of about 10% (2003 – 2006), although there might be exaggeration due to inaccurate statistical data. Inflation is relatively low, averaging 2% (2000 – 2006). The official rate for urban unemployment is 4.2% (2005); however, the Asian Development Bank estimates urban unemployment at 8.5% and rural unemployment at 30%. Government revenue exceeded 3 trillion yuan in 2005. Imports and exports totaled \$1.42 trillion (2005); by the end of 2006, the PRC amassed a trade surplus of \$168 billion. Realized FDI in 2005 was \$60.3. The central government deficit in 2005 was 295 billion yuan, down from five billion yuan in 2004. The main challenge for the Chinese government remains cooling down economic growth while maintaining a minimum growth of 7 to 8% a year in order to generate the 17 million new jobs required each year.

Output strength

12 | Sustainability

Since the late 1970s, the PRC has pursued a policy of economic growth first, regardless of the environmental impact. Consequently, China today is confronted with severe environmental degradation that also negatively affects economic development. For example, although economic growth reached 8 to 12% annually since the late 1970s, environmental degradation has eaten away 8 to 13% of that GDP growth each year. In 2004, economic losses due to pollution amounted to 511.8 billion yuan. Environmental degradation also undermines the leadership's legitimacy. Therefore, President Hu made environmental protection a priority and a vital component of building up a "harmonious socialist society." From 2001 to 2005, the central government invested 111.9 billion yuan on environmental protection and plans to spend an additional 1.6% of GDP annually for the next five years. The government also announced to cut energy consumption per GDP-unit by 20% and air pollution by 10% by 2010. However, as long as local officials are reluctant to implement environmental laws and even openly violate these regulations, it will be very difficult for the central government to effectively reign in further environmental damage.

Environmental policy

The government continues efforts to improve education and plans to raise government education expenditures to GDP from 3.41% (2002) to 4% by 2011. Funding is unevenly distributed across regions and institutions; spending is much higher in urban and coastal areas than in central and western provincial areas, and tertiary institutions receive more funds at the expense of primary and secondary schools. Regarding subjects, there has been a strong emphasis on technical subjects. Since rising costs for education have led to popular discontent and aggravated illiteracy in poor rural areas, the government plans to eliminate charges for rural students for the nine-year compulsory education system by 2007. In 2006, China spent over \$136 billion on R&D, becoming the world's second-largest investor in R&D after the United States.

Education policy
/ R&D

Transformation Management

I. Level of Difficulty

To date, structural constraints as understood in BTI terms are moderate. The PRC has a sufficiently educated labor force, adequate infrastructure and has not suffered from major natural disasters in recent years. Overall, poverty is in continuous decline. However, there are problems that could lead to severe constraints in the future if no adequate solutions are found. For example, as development grows increasingly uneven, income gaps and regional development disparities are bound to increase. Environmental degradation destroys the foundations of development; HIV/AIDS is dramatically on the rise in some areas; in the medium run, the education system must become more flexible and innovation-oriented in order to support high-quality development.

Structural
constraints

There is no tradition of, and only docile signs for, the development of civil society which could provide channels for popular unease; consequently, there is a high potential for the uncontrolled eruption of social discontent. This is illustrated by the 87,000 public disturbances, often violent, in 2005; compared to 2004 and 2003, the number of such disturbances increased by 6.6% and 50%, respectively.

Civil society
traditions

There are no irreconcilable ethnic, social or religious cleavages in the PRC. However, as the inequality of development – as indicated by widening wealth gaps, unequal access to health care, education – and thereby the fragmentation of society into a small affluent group and a much larger group of those who do not benefit accordingly from economic development, social conflicts become more likely. To date, it is primarily discontent citizens who have confronted the government; further development along social rifts due to unequal development cannot be ruled out.

Conflict intensity

II. Management Performance

14 | Steering Capability

The Chinese government pursues macroeconomic stability and economic development as its two main priorities. Regarding stability, the measures necessary for preventing the economy from overheating – such as monetary measures to curb the money supply and administrative measures to rein in excess investment – are implemented as stringently as possible, although in many cases it is difficult to overcome local governments' opposition. Violations of central policy prescriptions by local officials also result in massive social tensions and upheavals as more people protest illegal local government measures. Thus, in order to uphold the legitimacy of the CCP as well as of the government, it is essential that the central government succeed in disciplining local governments. Regarding development, there has been a shift in priorities. Whereas former Chinese leaders favored economic growth "at all costs," the present leadership is now ready to take into account the negative consequences of development, mainly environmental degradation and social tilts. Therefore, the establishment of a more social market economy has won priority. Since this paradigm shift confronts many vested interests – those of property developers, of businesses turning profit in negligence of environmental protection obligations, of local governments profiteering from excess development activities – it is not clear at this time whether President Hu will be able to firmly establish and maintain this new paradigm over periods of crisis. External influence does not significantly influence priority setting. This becomes especially clear regarding political development; despite continuous pressure to liberate the political system, the development of constitutional democracy is categorically ruled out by the leadership.

Prioritization

As President Hu sets out to establish a new policy agenda by promising to spread wealth more evenly, it becomes obvious that the implementation of reform measures is often compromised by the rise of so-called "special interest groups." These groups are mainly formed by central and local government officials and their relatives as well as national and foreign businesses. They bribe and collude with government officials, exploit legal loopholes, or profit from government monopolies in electricity, transportation, telecommunications and energy. Due to the influence of these groups, which also cooperate with the media and convince academics and governmental departments to argue their cases, some important

Implementation

reform measures – the anti-monopoly law, fuel tax, uniform taxation of foreign and domestic enterprises, digital television broadcast standards – found no support and thus remained unimplemented. It will be essential for the success of President Hu's economic and social reforms to bring down these groups; however, since even the children and relatives of senior central government officials belong to these groups, it will be very difficult to rein in their influence.

The new leadership around President Hu has been ready to acknowledge that the past priority on unrestricted economic development has created serious social problems, human hardship and the deterioration of the natural foundations for life and development. Therefore – not least because the legitimacy of the government and CCP is at stake – President Hu is striving to implement reform measures that emphasize more social equality and justice as well as sustainable development. However, these measures are confronted with strong opposition by special interests that benefit from unequal access to resources and influential decision makers and hamper the implementation of reform measures. However, even if more transparency, media freedom and public participation can be regarded as a safeguard against this sort of undue influence and accompanying corruption, the Chinese leadership is not yet ready to accept that more pluralism and democratic reforms are also urgent.

Policy learning

15 | Resource Efficiency

In many areas, resources are still not used efficiently. The efficiency of the public service and the judiciary is severely limited by corruption and misappropriation of funds. There is no efficient auditing and public oversight; public servants often neglect their duties and misuse their positions for personal gain. The arbitrary behavior of local officials hampers effective management at the subnational level. Appointments at all levels are often influenced by political or personal considerations, favoring political companions and family members. This became obvious when President Hu appointed several members of his political clique to leading provincial and party posts in autumn 2006. The ongoing need to subsidize ailing SOEs in strategically important sectors as well as state-owned lenders with high amounts of non-performing loans also leads to inefficiency. Profitable SOEs often invest their profits unwisely, thereby depriving the state of resources urgently needed for the support of social security systems, education, etc. Rapid growth of fiscal revenues, which hit 3 trillion yuan (2005), and strict expenditure controls resulted in a reduction of the budget deficit from 319 billion yuan (2004) to 300 billion yuan (2005) as predicted by the central government. Public debt was stable at about 23% of GDP.

Efficient use of assets

The Chinese government often fails to coordinate between conflicting policy objectives and interests. This becomes most prominent regarding the central

Policy coordination

government's recent emphasis on more sustainable growth, whereas local governments mostly thwart this policy by fueling excess development in their localities. The status of private property, and thus the status of the private economy, is still contested ideologically, as became evident during the debates about the draft private-property law. Finally, the need to cool down the economy and to rein in the excess growth of foreign currency reserves collides with the necessity to protect cheap exports as the main engine of growth, absent sufficient internal consumption.

Although corruption is punishable by law, government and CCP anti-corruption campaigns have proven largely unsuccessful. Only low-level, small-scale corruption has decreased, whereas high-level, large-scale corruption continues to increase. According to the 2005 annual report of the National Audit Office, no central government agencies were immune from financial misconduct. Since relatives of high-ranking political figures are also often involved in corruption, the implementation of anti-corruption is further exacerbated mitigated. As long as there is no sufficiently free media in the PRC, political and disciplinary anti-corruption measures will remain ineffective.

Anti-corruption
policy

16 | Consensus-Building

The Chinese leadership basically adheres to the aim of building up a socialist market economy. But the concrete design of this economic order has become more controversial. The "harmonious socialist society" doctrine proposed by President Hu, which favors more sustainable and socially just development, is hotly disputed. Since President Hu is only expected to fully consolidate his power during the upcoming party congress in fall 2007, these disputes will likely continue until then and the consensus-building capacity of the leadership under President Hu remains to be demonstrated.

Consensus on goals

President Hu is still in the process of consolidating his political power; so far, he has been able to exclude – most recently through cleansing campaigns related to anti-corruption – or co-opt political adversaries. However, intense bargaining about President Hu's most important political agenda – building a "harmonious socialist society" – continues. Since these processes are conducted behind closed doors by internal CCP organs, only the decisions taken during the next CCP party congress in late 2007 will demonstrate whether President Hu is able to successfully build up political consensus and permanently silence veto actors.

Anti-democratic veto
actors

Two decades of unconstrained economic development resulted in serious social distortions and cleavages between those segments of the populace with access to education, health care, social security, adequate incomes and living conditions, and those without. Violent eruptions of anger by groups of disadvantaged

Cleavage / conflict
management

citizens proliferated dramatically and Chinese society is in danger of falling apart along those social cleavages. The government's only solution so far has been violent suppression of demonstrations and intimidation of citizens. To date, it is not clear whether President Hu's new policy of more socially just development will be able to address these problems with efficiency and in a timely manner.

The political decision-making process is dominated exclusively by internal debates between CCP organs; even if developments of general concern such as health care, education and especially environmental problems and corruption are discussed broadly in society – not least with the help of the Internet – public opinion can hardly influence political decision-making. Quite to the contrary, in cases where public debates become too explicitly critical of political processes or developments, the debates are suppressed.

Civil society participation

As far as the major political injustices are concerned, such as the political persecutions during the Cultural Revolution and the 1989 Tiananmen massacre, the Chinese government, much the same as its predecessors, still is not prepared to acknowledge the faultiness of decisions and actions taken by past leaders. Any attempt to work through past historical wrongs is prevented.

Reconciliation

17 | International Cooperation

The PRC maintains and expands cooperative ties with external actors such as the IMF, World Bank, and the Asian Development Bank (ADB), as well as with foreign governments in order to obtain support for ongoing economic reforms. Technical cooperation with Western nations and with international actors, mainly in the area of law, to improve the implementation of WTO rules and to support the development of core national legislation, constitutes an important part of international cooperation. To date, China still receives the highest amount of ODA in the region, whereas Western ODA is mainly channeled into areas where resources are used mostly efficiently and in support of the transformation process. Moreover, in 2006, the Chinese government decided to favor foreign investment projects that not only attract capital into the country, but also transfer technology and know-how.

Effective use of support

With its proceeding integration into international regimes, the PRC has evolved into a generally reliable member of the international community, as well as a mostly dependable partner in bilateral relations. Sources for conflict remain, mainly regarding foreign trade and WTO commitments. For one, the EU is increasingly dissatisfied with trade liberalization and the implementation of WTO commitments by the PRC. Thus, in October 2006, the EU commission issued a new policy paper that threatened to initiate WTO litigations in the event

Credibility

that China does not fulfill its obligations. Frictions with the United States also increased due to a ballooning U.S. trade deficit with China of \$202 billion (2005), and accusations from Washington that the PRC keeps the yuan artificially undervalued in order to subsidize exports. China's trading partners are also dissatisfied with the PRC's insistence on its developing-nation status to exempt itself from global trade norms. International partners generally want China to assume more responsibility, not only for a healthy international trade system, but also for environmental concerns such as climate change. Moreover, international NGOs as well as foreign governments are highly dissatisfied that China has not lived up to promises to improve human rights, which was considered a precondition for bringing the 2008 Olympics to Beijing.

Cooperation between China and East Asian nations, especially with ASEAN, has improved significantly. China has successfully used trade, investments and aid in order to warm relations with ASEAN, China's fourth-largest trading partner with two-way trade amounting to \$130.3 billion (2005). Although ASEAN leaders are concerned about potential threats from China's economic might, both sides are strongly committed to creating a free trade zone by 2010. Sino-Indian relations have also improved; in July 2005, a Himalayan border crossing has been reopened for trade, and the Chinese government is planning to hold talks with India on creating a free trade area. The PRC is also holding free trade area talks with Singapore, Australia, New Zealand and Pakistan. China has increased cooperation with Central Asian nations such as Russia, Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan in the areas of economic and security cooperation (Shanghai Cooperation Organization), and cooperates with Central Asian neighbors in fighting money laundering and terrorism (Eurasian Group on Combating Money Laundering and Financing of Terrorism – EAG).

Regional cooperation

Strategic Outlook

During the period under review, the Chinese government succeeded in furthering economic development and transformation, although severe structural problems and risks persist. In quantitative terms, economic growth has been robust; however, the main growth engines are foreign trade and fixed-asset investment, which means that growth is not sufficiently self-supporting. Domestic consumption, which is vital for sustained growth, is grossly insufficient. In order to push consumption and thus stabilize economic growth, the government must increase citizens' incomes. Consolidating and expanding social safety nets constitutes the most important step in achieving this aim; to date, excess popular saving is induced primarily by the population's need to build up reserves for risks such as illness and unemployment, which are not (sufficiently) covered by social security programs. Furthermore, growth should concentrate more on quality than on quantity. The Chinese government's plans to favor foreign investment in technologically advanced segments, accompanied by the transfer of key know-how, are a step in the right direction. Finally, sustainability of growth must definitely become a priority lest the already severe environmental damages of the two past decades of unchecked development overburden and undermine economic development. Technical support in the form of green technology transfers as well as political and economic pressure from Western nations should convince the Chinese government to take responsibility for the environment.

China also faces severe problems in terms of social development. The increasingly unjust distribution of wealth and opportunity, resulting from poorly steered economic development, leads to social tensions that often erupt in violence. The Chinese government must act not only to correct aberrations and injustices in the country's economic and social frameworks, but it must also allow opportunities through which people can seek redress. Thus, nascent elements of civil society, such as NGOs, self-help groups, lawyer-activists supporting the disadvantaged, etc., should not be suppressed and intimidated, but instead should be co-opted by the government in order to support the build-up of a "harmonious socialist society." Foreign NGOs can help by providing financial and operational support in order to strengthen Chinese counterpart organizations.

To manage the tasks ahead with success, the Chinese government needs a high level of steering capacity. However, rampant corruption and arbitrary decision-making at the local level are eroding the government's authority and legitimacy and thus its capacity to implement national policies at all levels. The

government and the Chinese Communist Party (CCP) have not been able to cure these problems through administrative and disciplinary measures. Therefore, the Chinese government must accept that only mechanisms such as a free press and independent judiciary will be able to successfully control arbitrary officials and expose corruption. Foreign governments should be less shy in explicitly demanding corresponding reforms; as has been demonstrated with accession to the WTO, external demands can be exploited by reformist forces in the Chinese leadership as viable arguments to push for reforms.

Finally, since the daunting challenges of transformation process lie not only in economic restructuring but even more so in the realms of politics and society, foreign governments and economic actors should not focus exclusively on economic aspects when dealing with China; they should take these problems into account and offer adequate support.