The Changing Role of the State in Reform China

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The program of economic reform that has been under way for over twenty years has been accompanied by clear changes in the role of the state apparatus. These changes are especially clear if the role of the state is compared with the Maoist period when China operated its economy under a central plan that was matched by a centralized political and administrative system. There is far less direct involvement in the economy and people's lives, new institutions have been created to deal with law, international trade and a market economy, and the education level of administrators has improved considerably. However, while these changes are considerable, it is still the case that the Chinese Communist Party (CCP) is wrestling with what the correct role of the state should be in overseeing an increasingly marketized economy and pluralized society.

In 1978 before reforms began the state controlled almost all of the output from the service sector, 94.4 percent of agricultural production and 97.5 percent of industrial production was sold at state-fixed prices (UNDP, 1999, pp. 20-21). There was no notion of an independent financial or banking sector but rather they simply acted as the state's cashier, providing finance for state directed development projects. The situation now is dramatically changed with major consequences for the role of the state. The degree of market reliance has risen from 25 percent in 1979 to 63 percent in 1992 before the more dramatic reforms of the 1990s (UNDP, 1999, p. 39). The share of the non-state sector in industrial output rose from 22.4 percent in 1978 to 73.5 percent in 2000 while the private sector grew from 2 percent in 1985 to 16 percent in 1998 (Yusuf, 2000, pp. 24-25). The Chinese economy is now to all intents and purposes a mixed economy.

Despite these changes, the policies of the state and its organizational structure still do not reflect governance of a mixed economy with the continuation of preferential policies for the state-owned sector, progress but continuing bias against the private sector, and an administrative structure that cleaves too closely to that of the pre-reform era. One clear example is with credit policy where banks exist essentially to fund state-owned enterprises (SOEs), which receive 70 percent of bank lending.

Many observers expected that with the expansion of the market economy, the role of the state would decline in transitional economies, including China. However, this has not been the case and reform has brought with it state expansion into new areas while old functions have not necessarily been terminated. Indeed, a withering away of the state may not be the most appropriate approach. One of the primary problems in post-communist Russia has been the lack of an effective state apparatus to guide the process of market transition. A market economy without an effective enabling environment of rules and regulations implemented by a relatively impartial judiciary results in an anarchic free for all.

First and foremost an effective, as distinct from strong, state structure is a precondition for any hope of successful reform. Certainly, the role of the state in the economy will change with a narrower set of interventions and less direct administrative interference. Polanyi (1944), in his study of England showed how the expansion of the market went hand-in-hand with an increase in the power of the central state. An increase in state capacity is a prerequisite for an effective market to function. The state must adjudicate the increasingly contentious nature of economic market transactions. This means that it is the obligation of the state to establish a sound legal system. In addition, the state must manage the key macroeconomic variables and ensure that economic and investment policy is not distorted by price fixing or subsidy supports that have outlived their rational lifetime. It must deal with revenue collection and distribution, and this will help the state to provide minimum social services and welfare guarantees to protect those who are vulnerable in the shift to a market economy (among others see The World Bank, 1997, pp. 4-5).

Far from making governance easier, the shift to less administrative interference and curtailing the direct provision and administration of services makes it more complex. The Chinese state has added to its old monopoly functions new regulatory roles that are broader and more complex than before and that will become even more complex as China eases its way into WTO. The Chinese government needs to dismantle old ministries and organizations, adapt the roles of others while creating new ones to serve the needs of a WTO world. The required regulatory development is mind boggling.

Most current administrators are less familiar in a role where they would act as an indirect provider or a regulator. These new roles will require them to acquire additional skills and capacities to manage within a markedly different administrative framework. Pension reform is a good example of the new challenges. The central government has decided to shift responsibility for pensions of the privileged sector of the working-class from state owned enterprises to the local government. This entails local administrations dealing with complex matters of collection, pooling and disbursement. However, many localities lack the skills to manage these funds effectively and with insufficient transparency and regulation many have simply used pension funds as state property to be invested as they see fit in their pet development schemes. Even at the national level there are problems. During preparations for the establishment of the Ministry of Labor and Social Security (formally established in 1998) I visited officials overseeing pension fund policy and development. It was obvious that there were no trained economists working in the department who could provide projections of future funding needs based on demographic trends and differing projections for retirement age. This is just one small example of the new kinds of skills that have to be acquired by government officials to make the new system of governance effective. Given such problems of adjustment, it is little wonder that administrative reform is resisted and many ministries prefer to cleave to well understood tasks and roles rather than adapting to the new.

However, the experience of Russia shows that it is preferable to start with the existing social and political institutions and try to stimulate incremental transformation through the judicious use of incentives. An unregulated and ungoverned market will produce chaotic results. The alternative approach is what Stiglitz denounces as an "institutional blitzkrieg". Neither is wholesale privatization of functions an answer. The precise role that property rights plays in the transition process is more ambiguous than orthodoxy might suggest. As Rawski (1999) suggests, they may play a less important role than economists usually ascribe to them. Market structures and the institutional arrangements surrounding business enterprises often exercise greater influence over performance, efficiency and profitability than the nature of ownership (for China see Steinfeld, 1998). Private monopolies will not necessarily function any better than state-run ones, what matters is how the competition is regulated. The state as a large business is more likely to be interested in gaining a monopoly position than in securing fair competition for all.

So how are we to make sense of this with reference to the role of the state in China? Merquior's general assessment (1993) that "The truth is that we have simultaneously too much state and too little state" applies well to China. Or put another way, the Chinese state is too directly involved in those areas that can be better left to the market or civil society and has absented itself from certain key areas where the public goods argument supports greater involvement. Grindle qualifies Merquior's comment as "too much" meaning that government is too interventionist and often intrusive in terms of state-led development combined with an emphasis on centralized political control. The "too little" means that these large and intrusive public sectors often have little effective capacity to formulate policy, implement it and perform routine administrative functions (Grindle, 1997, pp.3-5). While the first is applicable to China, the latter is not the case across the board, but it is relevant to social policy development. In the remainder of this paper I shall consider three issues. The first concerns the "too much" of inappropriate industrial policy. The second concerns the "too little" of inadequate healthcare provision. The third concerns the fiscal capacity of the state of which there is "too little" and some of what there is is misdirected. As in many developing countries, the Chinese state is trying to do more than its resources can support. This requires the state to refocus its capabilities and concentrate on those areas where it can provide added value.

Too Much: Industrial Policy

One of the government's most significant policy challenges is how to reconfigure an industrial policy and associated fiscal policy that is premised on support to the state-owned sector of the economy. Indeed one might even ask if China needs an industrial policy. While there are strong political and ideological reasons for this bias, the sector is a net destroyer of state assets while the rapidly growing and more productive non-state sector is penalized and starved of the necessary capital for development.

The role that an active industrial policy plays in development has been much debated with many seeing this as a key factor in the success of the East Asian economies before the economic crisis (on the debate see Stiglitz, 2000, pp. 517-19). A number of writers have highlighted the Japanese and Korean policy of "picking winners" and then setting up trade barriers to protect them while providing them with directed credit from the banking system to help them expand. Depending on one's viewpoint, this is either seen as a sound strategy that contributed to take-off or the source of the ruin that came with the Asian Financial Crisis. On balance I would tend to agree with Stiglitz (1996) that this approach had some value in the early stage of development by protecting nascent industries and allowing them to develop and take advantage of economies of scale. However, recent research on Japan has suggested that subsidies in fact tended to shift resources from high to low productivity users (Noland and Bergsten, 1993) and that declining industries were favored over those that were fast growing. In addition much of the support went to those industries that only had modest future prospects but that for a variety of reasons were deemed in the national interest such as coal, petroleum and textiles (Beason and Weinstein, 1996).

This has certainly been the case in China where industrial and fiscal policy has supported declining sectors of the state-owned economy that the CCP created from the 1950s onwards. In addition, whether such a strategy of protectionism and "picking winners" did or did not work in the past, it is not feasible in a world of WTO. Rightly or wrongly, WTO regulations and practices try to prevent the kind of development strategy that was practiced throughout East Asia from the 1960s onwards. It is clear that international pressure will force the Chinese government to undertake a more market-based strategy. Should China not adjust its policy it will run the risk of substantial friction with the world trading body and especially from the USA.

It is clear that state-owned enterprises, on the whole, are struggling. Certainly rapid growth has been attained while maintaining a relatively large state-owned sector. Since 1978 GDP growth rates have averaged 10 percent per annum, 10.7 percent in the 1990s; by contrast those for Russia declined by 6.1 percent per annum in the 1990s. Government strategy has been to let the non-state sector grow up around the state-owned core in a process that Naughton aptly refers to as "growing out of the plan" (Naughton, 1995). However, maintenance of the state-owned sector is becoming increasingly problematic and it is causing increased financial fragility throughout the system while distorting investment patterns.

Reforming the industrial sector is the most difficult governance challenge for the CCP as it goes to the core of the economic system that was set up under the central plan. Reform undercuts the interests of powerful bureaucracies that were established to run the system and the working-class that the CCP was to represent the most advanced elements of. Not surprisingly reform attempts have been stop-go but by the latter part of the 1990s it was clear that difficult reforms could be delayed no longer. The problem of SOE reform provides a good example of the advantages and disadvantages of delayed reform. Gradualism allowed the non-state sector of the economy to develop alongside that of the SOEs providing alternative employment opportunities for new entrants and for laid-off industrial workers. In the absence of an effective government unemployment scheme, keeping superfluous workers in the SOEs provided an alternative to turning them out onto the streets where they may have formed a reservoir of the politically discontented. This is no longer financially viable. Economic pressures have made it impossible for the Center to remain on the fence while the localities were pursuing de facto privatization. The state simply did not have the money to keep bailing the sector out.

Delay in fundamental reform also derived from the lengthy learning process that the leadership has undergone in grappling with this sector. It took a long time for central leaders to realize that simply stressing technological up-grading, improved management, limited autonomy, and expanded market forces did little to improve the health of SOEs unless the external environment was significantly reformed and a proper sequencing of reforms introduced. Indeed, tinkering with these aspects could actually make the situation worse. China lacks the key institutional mechanisms needed to make corporate governance and by extension property rights function for producers in complex market settings. The problem is compounded by the fact that many SOEs have become net destroyers of assets, with what they consume being of far greater value than what they produce. The dilemma for the government is that they still provide significant revenue for all levels of government: in 1995 this amounted to 71 percent of total revenue.

Some figures display the seriousness of the problem faced in the mid-1990s. Of the 100 000 plus industrial SOEs, World Bank figures suggest that perhaps less than 10 percent were fundamentally viable. SOEs absorbed 60 percent of national investment; received total subsidies amounting to one-third of the national budget; and net credit to SOEs reached over 12 percent of GDP in 1995. Importantly, 50 to 75 percent of household savings, mediated and directed by state banks, went to finance SOE operations. The World Bank (1997a, p.1) estimated that in 1996 50 percent of SOEs lost money (unofficial estimates are higher). Showing the range of the activities, SOEs employ fully one-third of China's medical staff and some 600 000 teachers and administrators (Hughes, 1998, p. 73).

It must have become apparent that over the long-term government resources would be insufficient to pay depositors and bond-holders if SOEs were unable to service bad debts. At the same time, the state with a declining revenue base was unable to offer the same kind of bail-out and subsidies declined. This made it virtually impossible for many SOEs to meet their full range of social obligations, and even salary payments, thus in turn speeding up the need for pension, medical, and housing reform. The cost of social insurance and welfare funds as a proportion of the total wage bill rose from 13.7 percent to 34 percent in 1995 (UNDP, 1998, p. 65). It is not surprising then that bankruptcies in 1996 rose by 260 percent on the year before and that lay-offs are rising despite official concern about the pace. The total of 6232 bankruptcies exceeded the total for the previous seven years combined.

Such statistics have led the party leadership to decide, in a risky venture, to cut themselves loose from the working-class that they created in the 1950s and to reduce working-class expectations about what the state can provide. Rhetoric is still paid to the importance of working-class leadership and policy is to give priority to finding work for laid-off workers. The reality, however, is that for many they are on their own to find new work in an economy that is increasingly unfamiliar to them and that requires very different skills than those they learned under the Soviet-inspired system.

A number reform initiatives related to governance have been pursued including: encouraging SOEs to pull out of certain sectors of the economy, clarifying ownership rights, separating the enterprise from government administration, and forming large enterprise groups that would be able to compete on the international market while allowing smaller SOEs to diversify ownership. This policy for the 1000 or so largest enterprises may seem strange given the problems that the *chaebols* of South Korea and the *keiretsu* of Japan have run into. The Chinese leadership believes that this strategy is still viable at its development stage. In addition ideological factors, the remnants of socialist ideas on industrial development, and nationalistic ones, to get a number of Chinese companies at the top of the Fortune 500 list, have perpetuated the desire to privilege this sector.

From the mid-1990s two important further reforms were introduced to attempt to improve the sector. The first was the establishment of a social welfare system independent of the individual enterprises and regulated through the government. The second was to harden the budget constraints by gaining control over bank loans, trying to introduce better discipline over lending, and commercializing loans.

Has the policy of revitalizing the SOE sector worked? On paper yes but emphatically no in reality. By the end of 1999 and throughout 2000, officials were beginning to highlight figures that showed the situation for loss-making SOEs beginning to turn around. In August 1999, the official *People's Daily* claimed that in the first half of 1999 profits had risen by 280 percent, with a major improvement in the Northeast. Here the number of loss-making enterprises was said to have fallen by 29.1 percent, while that of profitable enterprises had risen by 14.6 percent. In March 2001, the head of China's State Development and Planning Commission declared that the 6599 loss-making SOEs that made losses in 1997 had been cut by over 70 percent. This turnaround is not surprising. First, many of the really hopeless cases have been taken off the state books through mergers and acquisitions with more profitable companies. Second, Asset Management Companies (AMCs) have bought up the debt for many of the larger enterprises and thus it has been moved off the books of the SOEs. Most importantly, the SOE is no longer paying a large amount of interest on its bad loans. In this way many bankrupt SOEs have turned around from basket cases to seemingly profitable enterprises overnight (for a critical review of this policy see Steinfeld, 2000, pp. 22-27). Whether the problem of SOE inefficiency is really resolved or not is an entirely different matter and many of the SOEs have avoided the necessary structural reforms to enable them to compete in the future WTO market.

China will need to move more quickly on governance in this area unless it wants to provoke a financial crisis that will be exacerbated by WTO entry. The state needs not only to withdraw from direct involvement in the sector but also to end preferential policies and lending practices that redirect valuable resources to a declining sector that is unlikely to turn around. However, this does not mean there is no role for the state. China needs to develop a better capacity to guide economic development through indirect mechanisms and to develop more effective regulatory structures that support competition. While reducing its direct control over the economy, it needs to develop new skills to manage economic affairs through fiscal and monetary policy, an area that is gaining ground in China. For those areas where the government is reluctant to withdraw, it needs to develop practices that provide greater transparency and accountability.

Too Little: Rural Healthcare Delivery

By contrast with industrial policy, there has been too little state involvement in healthcare, especially with respect to the delivery of services in poor rural areas. However, this should not be taken to mean that the state should cover all forms of health care and while privatization may be possible for some services, high-end urban healthcare for example, or for public-private partnerships, the poor are a clear case for state provision. Curative care, which is the focus of current policy, is effectively a pure private good that if the government does not provide the funding, all but the poorest will find alternative ways to cover the costs (see The World Bank, 1997b, p. 52). Preventive medical care is quite a different case and is clearly a public good with large externalities that is currently underprovided in China and will not be provided no matter how much the private sector and the market develop.

Reforms, especially financial decentralization, have produced new inequalities, a dramatic rise in the disparity between welfare provision in rural and urban China, and an abandonment of the compact for cradle-to grave social welfare for the privileged working-class. While the reforms may have raised the standard of living for the vast majority and shifted China along the road to a market economy, China's policy-makers have not been so successful in devising policies to bridge the social transition. This is not surprising, as reforms entailing major institutional change are inherently slower and more complex than macroeconomic stabilization and liberalization measures (Nelson, 1997, p. 256).

Financial pressures resulting from the reforms have caused many work-units and local authorities to cut services or turn them over to a fee-for service system. Individuals are left increasingly to find the best support available with their own resources. This has been particularly noticeable in the provision of healthcare (see Bloom, Tang and Gu, 1995, pp. 423-41, Liu, Hsiao, and Eggleston, 1999, pp. 1349-56, and Saich, 2001, pp. 241-71). Combined with the rising income inequality, the financial pressures on the local state in China are accounting for the huge variation in the provision of public goods and services during the transition. As the World Bank has shown, access to health and education services was still widely available in the 1980s but became more dependent on incomes in the 1990s (The World Bank, 1997c, p. 23). For example, in 1998 22.2 percent of those in high-income areas were covered by co-operative medical facilities but only one to three percent in poorer areas were covered (Zhu Ling, 2000, p. 41-43).

Government health spending has been inadequate and the budgetary allocations are heavily biased towards the urban areas. Annual healthcare spending is only around 3.8 percent of GDP, as against WHO recommended levels for developing countries of 5 percent (Bland, 2000, p. 273). In fact the state's financial commitment to rural health services has been declining as a percentage of the total medical and health expenditure from 21.5 percent in 1978 to 12.1 percent in 1985 to 10.5 percent in 1991 (Wong and Chiu, 199?, p. 274). Rural spending was two-thirds of the national average while that for urban China was almost twice the national average (Economics Research Department, 2000, p. 25).

During roughly the same period, the actual cost of care increased dramatically. The impact for poor rural households on healthcare access is particularly dramatic. Annual medical expenses per capita rose from between 2 to 3 percent of total income around 1990 to eight to eleven percent of income in poor areas 1998 and has continued to rise (Liu, Zhen, and Wen, 2000). With the loss of the pre-paid collective medical system with the disbanding of the communes in the early 1980s, some 90 percent of rural households have to pay directly for almost all of the health services used (The World Bank, 1997c, p. 47). Thus, not surprisingly, illness has a close correlation with poverty and cost of provision is a major factor influencing utilization by the poor. One 1995 survey of 60 poor families cited major medical expenses as the most important cause of poverty (Kaufman, 1998, p. 68). Cost affects hospital utilization with one survey finding that 65.25 percent of rural dwellers cited economic hardship for not staying in hospital (63.13 percent in urban areas) (Meng and Hu, 2000, p. 68).

The basic problem of healthcare delivery derives from the change of the ownership structure of village networks and the nature of the incentive system that has arisen from these changes (UNDP, 1998, pp. 36 and 38). From 1981 health care facilities were instructed that they should cover recurrent costs, with the exception of staff, from user charges and by the mid-1980s preventive care facilities were also charging on a fee-for-service basis (Hu and Jiang, 1998, p. 192). This caused the drop in participation in the cooperative medical schemes noted above and the shifting of health cost burdens to the household. Thus in terms of national health spending, while the collective schemes accounted for 20 percent in 1978, by 1993 they only accounted for 2 percent (UNDP, 1998, p. 37). As the World Bank concluded in its 1996 report, “the downturn in China’s health performance relative to its income level coincided with agricultural reform that reduced the ability of the village to tax the peasants” (The World Bank, 1996, p. 127).

In addition, direct government support has been dropping. One intent of the financial decentralization was to allow townships to increase healthcare funding. This may have been the case in wealthier areas but on average it has not been the case, especially in the poorer townships. In Donglan County, Guangxi Autonomous Region, government covered 46 percent of the income of the county’s health centers in 1981 but this had declined to only

32 percent in 1994 (Tang and Bloom, 2000, p. 194). A 1992 study of three poor counties showed that government funds supported 18 percent of county hospital budgets and 26 percent of those for township health centers, down from 34 and 38 percent eleven years earlier. This means that increasingly such facilities are raising funds from fees from patients and from drug prescriptions (Bloom, Tang, and Gu, 1995, pp. 426-27).

With medical facilities there has been a growth in private medical provision and a shift away from preventive medical care to fee-for-service with local governments in poor areas less able to provide adequate support. This increases the financial burden on the rural household that in the absence of sufficient state financing must provide the necessary social support.

The Central government has now recognized that its health system is in significant distress, especially in the rural areas. The change in tone at the December 1996 National Conference on Health was remarkable as the leadership shifted from presenting its system as a shining example to other developing countries to one of concern about its collapse (Discussions with participants and Cailliez, 1997, pp. 42-43). The Conference called for spending in the national budget to be raised from two to five percent, something that has not been achieved.

There a number of things that could be done to improve the lot of the poor regions but without a strong constituency of support at the political center it will be very difficult. The most beneficial change would be to abandon the urban bias of development policy that has been a hallmark of CCP rule since 1949. This will not happen given the strong vested interests of the CCP and the marginality of rural constituents in the policy process. However, if the CCP could clear up the state-owned enterprise sector, a prime destroyer of state assets, this could have enormous beneficial effects for rural China if part of the current subsidies were diverted to productive investment in the countryside. Rural healthcare provision appears to be a clear case where the "public goods" argument applies. The central government needs to tighten the regulatory framework to ensure that guidelines on health are followed and that in poor areas better provision needs to be provided at central government expense. The Central government would be well served to be the provider and supporter of public health, ensuring more equitable access, rather than focusing its efforts on subsidizing the salaries of those in the health system (on these issues see Saich and Kaufman, 2001). Comparative research in a number of developing countries has shown that especially in the social sectors it may be better to boost direct provision of services by government agencies rather than setting up new contractual deals (Batley, 1997).

Not Enough: Fiscal Capacity

For China to meet its governance aims effectively, it requires an adequate fiscal capacity but its finances are insufficient and some are not directed optimally. During the Maoist period, the state used revenues from SOEs with government controlled prices and distribution mechanisms to ensure that the enterprises enjoyed high profitability. This meant that the national savings rate was high (UNDP, 1999, p. 75). As we have seen above the reforms have undermined this structure and the state is severely challenged to meet its investment needs and to supply adequate public goods and services. With limited revenues, the government must select those activities where it can have the greatest impact or as in the case of rural healthcare provision have an obvious public good function.

Most writers have correctly pointed to the decline in central revenue as a primary cause of the reduction in central state capacity. However, the more important factor is the shifting balance between central and local budgetary streams and the incentive system for local officials. State revenues only amounted to 14.2 percent of GDP in 1999, down from 36 percent in 1978 and they had dropped as low as 11 percent. This has severely restricted the central state's redistributive capacity and has meant that local governments have been largely left to their own devices to raise the necessary funds for development priorities. The relative decline in state revenues has created pressures at all levels and in all Chinese government agencies to meet recurrent costs from the locally generated revenues. This means that local resources and power structures increasingly determine political outcomes. Within the same province and even in adjacent counties one can see radically different socio-political outcomes deriving from the reforms.

Before the most recent fiscal reforms (1993-94), only about one quarter of all state expenditures occurred at the central level and the major responsibility for financing infrastructure and providing social welfare occurred and still occurs at the local level. Thus, the localities are still dependent on their own income generation to fund activities. This comes from two main sources: extra-budgetary funds (EBF) and self-raised funds (*zichou zijin*) (for township revenue sources see Li, Wang and Tang, 1985, pp. 35-36). Not surprisingly, it is difficult to calculate what the real value of the EBF is. Christine Wong has estimated that the EBF amounts to 12 percent of GDP, compared to an official budget of 14 percent (Wong, 2000). If one adds the self-raised extra funds that by their very nature do not turn up in the statistics, the total sum of revenues available were the same in the early 1990s as at the start of the reforms; 39.5 percent as compared with 40 percent (Zhang, 1999, p. 123). This means that those observers who have suggested that there has been a major decline in the state's extractive capacity have relied on the official budgetary revenue and this has indeed declined by almost 60 percent (but not in absolute terms as the economy has been growing at a rapid rate). There has not so much been a decline in the extractive capacity of the state under reforms but rather a realignment between the Center and the localities with the localities controlling far greater amounts of revenue than previously (Yang, 1994, especially pp. 61 and 64).

This realignment has had a significant impact on the nature of the central and local state. By 1992, the central government's share of revenue was almost 39 percent, having declined from 51 percent in 1980, while collection had risen to 28 percent from 20 percent, and expenditure had dropped from 51 percent to 31 percent (Zhang, 1999, p. 120). The 1994 fiscal reforms have redressed this situation somewhat. The ratio of the budget to GDP has been raised as well as the ratio of centrally collected revenue to total budget revenue. The share of centrally collected revenue rose from 22 percent in 1993 to 56.5 percent by 1997 (Zhang, 1999, p. 131). For the first quarter of 1997, the growth of centrally collected revenue was reported to be on a par with that of locally collected revenue, thus overcoming the initial tendency of the localities only to collect for themselves. The Center's share of budgetary revenues grew from 2.8 percent of GDP to 6.2 percent in 1998 (Chung, 2000, p. 46). This is not sufficient, however, for the central state to play a major role in redistributive policy given its other financial obligations. The original objective was to provide the Center with a sufficient financial surplus so that it could cover both its own obligations and certain redistributive needs. It was estimated that the Center would need some 60 percent of collected revenues; of which 10 percent could be used to meet the redistributive and related goals (information from Pieter Bottelier). This objective of the 1994 reforms has not been met. These factors are is of vital importance for understanding the incentives for the local state.

The interest for local governments is still to concentrate on raising EBF and self-raised funds. Once a fee collected by a local government is reclassified as a tax, it is subject to revenue sharing agreements with higher level administrations. The fees are the funds that the localities can use to finance their own requirements, including their own salaries and related administrative costs. Particularly important are the management of local enterprises that can provide revenue to the local government and the use of other state assets such as land to rent out for commercial activities. In fact, rather then frowning on commercial activity, local governments are positively encouraged to use state assets to raise funds to cover their management and operational costs. This became especially important with the return to household-based farming that removed agriculture as a source of viable financing for local governments (Oi, 1992, p. 115). The 1994 reforms have heightened the tendency to seek off-budget revenues, as they require local counties to hand-over 75 percent of value added taxes but they have increased obligations.

It is important for the Central state to bring these EBFs into the formal fiscal system if it wants to meet any redistributive goals. The EBFs are a major contributor to inequality across administrative regions in China and the implicit tax rates of the EBFs are certainly higher in poorer regions (UNDP, 1999, p. 83). In addition, the central state needs to boost further its work to prevent tax evasion. It is clear that China, like many other developing countries, only collects a small amount of the taxes that are owed. Local governments allowing a myriad of tax breaks for investors and various forms of exemption have also weakened fiscal capacity. The government will need to create a regulatory environment and institutional framework that can support a more diversified financial system and to develop domestic capital markets. At the same time, it needs to move further to ensuring that the financial system is not essentially geared to financing the SOE sector.

Concluding Comments

The role of the state in China has changed enormously over the last twenty or so years reducing its direct role in the economy, curtailing interference in the daily life of its citizens, and with its slow and somewhat grudging acceptance of the need to develop the institutions of civil society. However, much remains to be done if it is to shift, to use the World Bank's phrase from "rowing" to "steering" future development (The World Bank, 1997, p. 164).

Increasing the state's fiscal capacity will go a long way to resolving many of the governance challenges that China is facing. However, as the paper has argued this alone is insufficient. A major re-think of the state's role is required to adapt the current governing structures to an increasingly marketized economy open to international competition. In some areas such as industrial policy this will mean doing less and doing it in different ways through indirect levers such as fiscal and monetary policy. In other areas such as rural healthcare, it will involve greater targeted state involvement to benefit those who have not profited so well from the economic reforms. In yet others such as the financial sector and environment (not discussed above) it brings new challenges to create new institutions and policies. This all suggests that with increased marketization and openness the state in China far from withering away needs to strengthen its capabilities in many areas of regulation and enforcement to provide an enabling environment for the market and civil society to grow. At the same time the state needs to shed many of the functions that it has inherited from the days of central planning.

In addition to the issues raised in this paper the state needs to address the problems of corruption and transparency, building administrative capacity, especially at the local levels of government while trimming the number of agencies and individuals working in government. In particular, the state needs to recognize that it is no longer the sole actor guiding development in China and indeed in some areas may no longer be the most important one. This entails considering how to develop new partnerships with the business sector and with its citizens. This could include the creation of public-private partnerships for the provision of goods and services, or in some cases, contracting the provision out entirely or relinquishing the role to society. If the Chinese state is not able to meet these challenges it will find itself as a break on further development rather than a facilitator.

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