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Executive Summary

Mid-term Evaluation of China's 11th Five Year Plan

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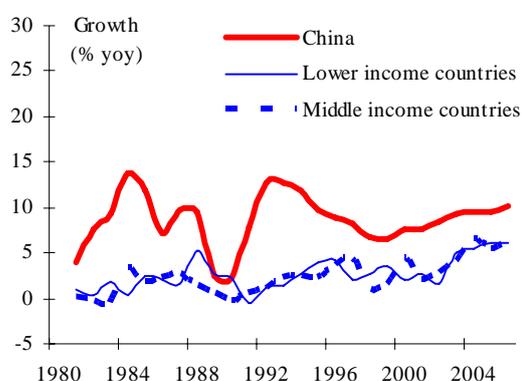
Mid-term Evaluation of China's 11th Five Year Plan

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Situation Prior to 11th 5YP

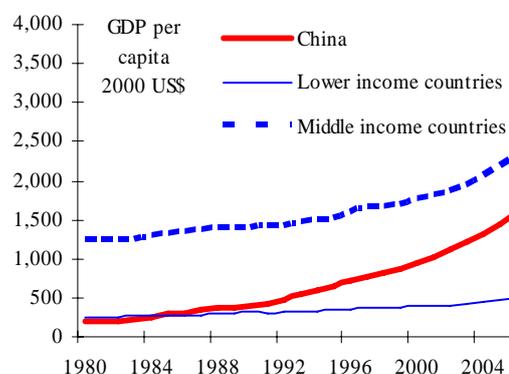
1. When the 11th Five Year Plan (5YP) was formulated in 2003-05, China had enjoyed an extended period of rapid economic growth, poverty reduction, and increasing integration with the global economy. Since the onset of economic reforms and opening up three decades ago, China's economic growth had been in a league of its own, surpassing that of low income countries (LICs), middle income countries (MICs), and other BRICs (Brazil, Russia, and India) (Figures 1 and 2). GDP growth had averaged about 10 percent per year, with reduced volatility and generally low inflation from the mid-1990s. Poverty had fallen sharply on all definitions; on the cost-of-basic needs benchmark, poverty had declined from 65 percent of the population in 1981 to about 7 percent in 2005, lifting hundreds of millions out of poverty at an unprecedented rate. China had also integrated swiftly into the global economy via trade and foreign direct investment, culminating in China's accession to the WTO in 2000.

Figure 1 China's GDP Per Capita Growth Has Been Very Rapid



Source: World Development Indicators, WB

Figure 2 This Has Allowed China to Catch up with Other Countries



Source: World Development Indicators, WB

2. Reforms also increased the market orientation of China's economy. The role of the private sector and market mechanisms expanded steadily, while direct government control over economic activity diminished. Product and factor markets gradually became more integrated. One exception was the financial sector, where reforms lagged and all major banks remained state-owned, dominating the financial system. But even here progress was marked. The government had recapitalized the major state banks, invited strategic partners, raised funding in capital markets, improved the supervisory and

regulatory framework, and aimed at reforming internal management and controls. And, in parallel, capital markets were expanded and deepened. Finally, fiscal revenues, which had been pressured during the early years of reforms, had recovered since the mid-1990s.

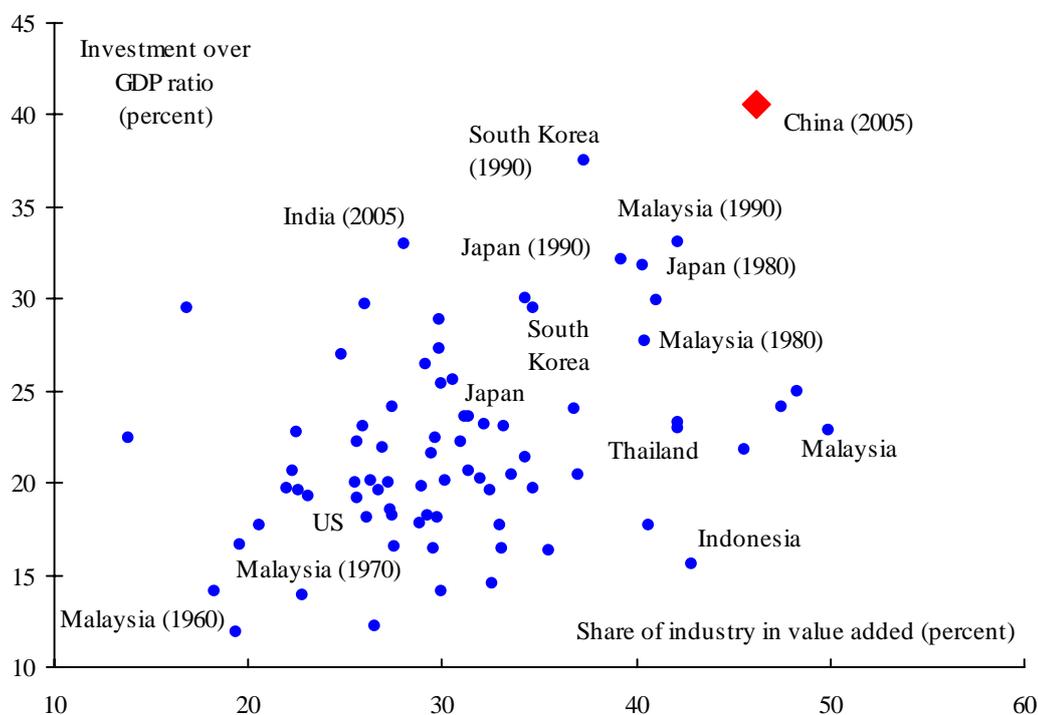
3. **Despite – or perhaps as a result of -- these achievements, the attention of policy makers focused increasingly on growing economic and social imbalances that emerged as a result of China’s rapid growth.** These imbalances included:

- Heavy reliance on investment and exports for economic growth, at the expense of domestic demand, especially consumption. This was reflected in a large and growing external current account surplus that reached 7 percent of GDP in 2005.
- Domination of industry, especially heavy industry, over the services sector (services make up 40 percent of GDP in China, compared with an average 54 percent in middle income countries and 70 percent in high income countries).
- Rapid increases in the demand for energy and other resources. China’s primary energy consumption grew by 62 percent during 2000-05 largely because of its capital-intensive, industry-led growth. China’s energy intensity also climbed, reversing a trend decline since the start of market reforms. By 2005, it was 43 percent higher than in India and 73 percent higher than in the U.S., based on PPP GDP. Excessive withdrawal of water from surface and underground resources caused acute water scarcity in the northern plains.
- Widening disparities in regional development and incomes, between urban and rural areas and coastal and inland provinces.
- Pronounced unevenness in access to basic public services between urban and rural areas. Social protection remained inadequate, especially for vulnerable groups including large numbers of rural-urban migrants. Access to education was uneven between urban and rural areas; the health system was poorly developed in rural areas, and there was a general lack of access to affordable health care.
- A mixed record in the improvement of environmental quality. While air quality had improved in many cities, and water quality had improved in the south, overall emissions of key pollutants had increased, as has the production of solid waste. China is now home to 13 of the world’s 20 most polluted cities. Land use patterns created tensions among the conflicting demands of urbanization, farmers’ income, and environmental protection.

4. **In no small part, these imbalances were an outcome of China’s capital-intensive, industry-led pattern of growth** (Figure 3). China’s growth had been capital intensive, with the investment to GDP ratio rising to almost 43 percent in 2005 and—using growth accounting—capital accumulation accounted for over 60 percent of GDP

growth during 1993-2005. From a sectoral perspective, China's growth was driven especially by industry, which during 2003-2005 accounted for over 60 percent of all GDP growth. The burgeoning profits of industrial firms, together with cheap credits from state banks, were invested in additional capacity. Industrial growth was associated particularly with increases in labor productivity, less so with employment growth, reflecting in part labor shedding by SOEs. Moreover, with industry taking the lead, service sector development lagged (the share of services in GDP was 40 percent in 2005, compared to an average of 54 percent in middle income countries and 70 percent in high income countries). As a result, urban employment growth, while robust, was not as high as it could have been, given China's rapid overall growth.

Figure 3 China's Capital-Intensive, Industry-led Economy in International Perspective 1/



Sources: World Development Indicators, NBS (for China), and staff estimates.
1/ 2001, unless otherwise indicated.

5. **This capital-intensive, industry-led pattern of growth was a key driver of the imbalances outlined above.** First, the capital-intensive, industry-led growth had been particularly intensive in energy, natural resources, and environmental degradation, thus accentuating the associated imbalances noted above. While energy and natural resource intensity was declining in several sectors, the relatively rapid growth of industry increased the weight in GDP of the most energy and resource intensive sectors. Second, capital-intensive growth created fewer jobs than a services-led growth pattern, limiting the absorption of surplus agricultural labor and contributing to the rising rural-urban income inequality and rural poverty noted above. Third, capital-intensive growth resulted in a declining share of wage income in GDP—a key driver of the declining share of

consumption in GDP, the rising share of investment, and a ballooning external current account surplus.

6. **Government policies helped accentuate China’s capital-intensive, industry- and export-led growth pattern.** Thus, while serving the economy well in several regards, policies indirectly accentuated the imbalances noted above. Policies encouraged saving and investment, with government spending geared to investment in physical infrastructure more than health and education, and biased to richer, coastal areas. Industrialization was promoted via easy access to cheap credit for large industrial firms, as well as by under-pricing key inputs, including capital, energy, natural resources, land, and the environment. The reluctance to move to greater exchange rate flexibility and allow the exchange rate to appreciate further stimulated exports and industry. The priority accorded to industry meant that services lagged. The *hukou* system restricted rural-urban migration and limited access to urban public services for migrants, further accentuating capital intensity, but at the same time dampening the rate of urbanization and avoiding the formation of urban slums.

The 11th 5YP: A Turning Point in China’s Development Strategy

7. **The 11th 5YP reorients policies to correct these imbalances.** In a major shift from previous plans which had quantitative growth as the dominant objective, the 11th 5YP gives priority to rebalancing the economic structure as well as to environmental and social objectives. It recognizes that economic, environmental, and social objectives are intertwined. The guiding principles and policy orientation seek to rebalance China’s growth pattern, with domestic demand, especially consumption, as the main driver, and services as the leading sector. This, in turn, is expected to better balance economic growth with resource conservation, energy efficiency, and environmental protection. Moreover, rebalancing the pattern of growth is expected to help mitigate the urban-rural divide, promote more balanced regional development, and improve basic public services, especially social protection, health, and education. To meet these objectives, the 5YP sets out 15 main tasks and strategic priorities, which in turn are supported by 22 quantitative benchmarks, of which 8 are obligatory and 14 are anticipative. A three-tier monitoring and evaluation framework was developed with a large number of quantitative indicators, although this does not seem to be operational yet. The overarching goal is to deliver a more people-centered growth and development that is more sustainable and equitable, thereby creating a more “harmonious society.”

Implementation of the 11th 5YP: Progress to Date

8. **This mid-term review has been undertaken to assess progress in the implementation of the 11th 5YP during its first two years and a half, draw preliminary lessons, and make recommendations for policy adjustments.** The review examines the following strategic objectives: ensuring the stable operation of the macro economy and improving living standards; optimizing and upgrading of industrial structure; increasing energy efficiency; coordinating urban and rural development;

improving basic public services; and enhancing sustainable development.

9. **During the implementation of the 11th 5YP, China has been buffeted by various exogenous shocks.** Domestically, natural disasters—the severe storms last winter and the recent massive earthquake in Sichuan—took a heavy toll. Externally, global demand has slowed owing to the slump in the U.S. housing market and the related credit crisis and increased risk aversion. International oil, food, and other commodity prices have soared. These developments pose new challenges. But they also reinforce the appropriateness of the policy priorities of the 11th 5YP to increase the economy's resilience and ensure sustainable growth.

10. **The 11th 5YP overall provides useful guidance to policy makers.** The objectives and tasks set out in the 5YP are consistent with China's development challenges and government priorities. Moreover, the quantitative indicators generally accord well with the overall guiding principles, orientations, and objectives, suggesting that these have been successfully put into operation.

11. **Many policies, programs, and regulations have been put in place recently to achieve the plan's objectives.** These include high-level political directions, broad strategies, specific administrative and policy measures, as well as the establishment of new institutions, regulations, and standards. On the whole, these measures were comprehensive and relevant to the objectives.

12. **Progress toward achieving the major objectives of the 11th 5YP has varied** (Table 1).

- Economic growth has far exceeded expectations.
- Considerable progress has been made toward the 5YP's most important social objectives: improving basic public services in social protection, education, health, and conditions in rural areas (even though income disparities between rural and urban areas continue to widen).
- Progress on the environmental objectives has been mixed: insufficient progress has been made in reducing energy intensity, but improvements were seen in reducing air and water pollution, treating industrial solid waste, increasing the efficiency of water use, and expanding forest coverage.

13. **Broadly speaking, the progress achieved so far can be attributed to several key factors.** These include a high level of political commitment, generally adequate administrative capacity to roll out new initiatives rapidly, strong public support for the objectives, an adjusted accountability system that links implementation to performance assessment of local officials, and increased central funding. The policy measures introduced were comprehensive and relevant to the objectives.

14. **However, little progress has been made in rebalancing the overall pattern of**

growth, which has in turn limited progress on other key objectives. There has been little rebalancing away from industry and investment towards services and consumption. This, in turn, has made it difficult to meet the objectives on energy efficiency, the environment, and reducing the external imbalance. The lack of decisive rebalancing has also made further widening of urban-rural income inequality almost unavoidable, despite strong government efforts. Going forward, rebalancing would help meet these objectives and solidify the social gains that have been achieved. The policy agenda for rebalancing is broad ranging, involving macroeconomic policy adjustments and structural reforms, as discussed below.

Table 1 China's Progress in Meeting the Quantitative Indicators under the 11th 5YP

Category	Indicator	2005	2007	2010	Type of
		actual	actual	target	Target 1/
Economic growth	GDP (RMB trillion)	18.4	25.0	26.1	A
	GDP per capita (RMB)	14,103	18,885	19,270	A
	Share of services in GDP (%)	39.9	40.1	43.3	A
Economic Structure	Share of services in total employment (%)	31.4	33.2	35.3	A
Structure	Ratio of R&D expenditures to GDP (%)	1.2	1.4	2.0	A
	Urbanization Rate (%)	43.0	44.9	47.0	A
Population, resources, and environment	Total Population (100 mln)	13.1	13.2	13.6	O
	Reduction of energy use per unit of GDP (%)	0	4.6 2/	20.0 3/	O
	Reduction of water use per unit of industrial VA (%)	0	...	30.0 3/	O
	Efficiency coefficient of irrigation water	0.45	0.46 4/	0.50	A
	Compreh. utiliz. rate of industrial solid waste (%)	56.1	61.2	60.0	A
	Total cultivated land (mln ha.)	122.1	121.7 4/	120.0	O
	Reduction of total major pollutants emission (%)				
	COD	na	2.1 2/	10.0 3/	O
	SO2	na	3.2 2/	10.0 3/	O
	Forest Coverage (%)	18.2	...	20.0	O
Public Services and Quality of Life	Average number of years of schooling (yr)	8.5	...	9.0	A
	Population covered by basic urban pension (100 mln)	1.7	2.0	2.2	O
Services and Quality of Life	Coverage new rural coop. health system (%)	75.7	85.7	80.0	O
	New urban employment in five years (mln)			45	A
Quality of Life	Rural labor force transferred in five years (mln)			45	A
	Registered urban unemployment rate (%)	4.2		5.0	A
Life	Per capita disp. income urban households (RMB)	10,493	13,790	13,390	A
	Per capita net income rural households (RMB)	3,255	4,140	4,150	A

Sources: China's authorities, NBS, and staff estimates.

1/ A = Anticipated; O = Obligatory

2/ accumulated reduction in 2006-07

3/ Targeted accumulated reduction in 2005-10

4/ 2007 data not yet available. This is the 2006 data.

Looking more specifically at the major objectives of the 11th 5YP:

Stable Operation of Macroeconomy and Improved Living Standards

15. **China has broadly succeeded in combining rapid growth with low inflation.** During 2005-07, GDP growth accelerated to nearly 12 percent annually and per capita income growth rose rapidly in urban and rural areas even as the gap between rural and

urban incomes widened (Table 2). But little progress was made in rebalancing the underlying drivers of growth, which on the sectoral side continued to be industry, and on the demand side, investment and exports (Figures 4 and 5). The labor-intensive services sector continued to lag behind industry, but with overall economic growth so strong, urban job creation remained robust. Preliminary data indicate strong poverty reduction in the first 2 years of the 11th 5YP period. China is affected by the global financial turmoil and slowdown, with growth in end-2008 and early 2009 expected to be particularly weak. However, the medium-term growth outlook remains good and the 11th 5YP's objectives for overall and per capita income growth will likely be achieved.

Table 2 Indicators on the Macro Economy and Living Standards

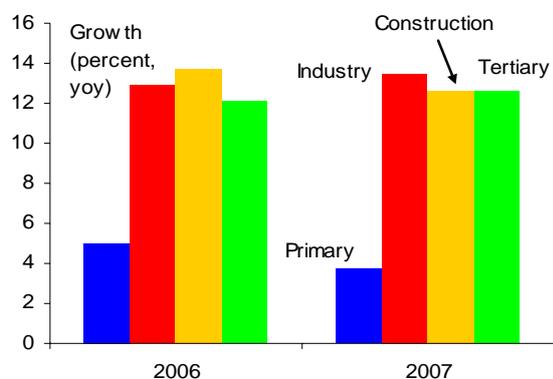
	2005	2006	2007	2008 WB 1/
Real GDP (production side)	10.4	11.6	11.9	9.4
Consumer prices (period average)	1.8	1.5	4.8	6.5
Fiscal balance (% GDP)	-1.2	-0.5	0.7	-0.4
Current account balance (% GDP)	7.1	9.5	11.3	9.3
Real urban p.c. income (%)	9.6	10.4	12.2	...
Real rural p.c. income (%)	6.2	7.4	9.5	...

Source: NBS, SAFE, Ministry of Finance.

1/ World Bank Forecast, December 2008.

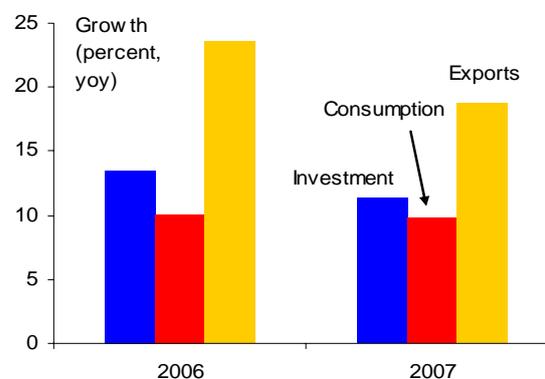
16. **In 2007 and much of 2008, headline inflation was high as a result of sharply rising international and domestic food prices.** The impact of higher international oil prices on inflation was more muted due to price controls, even with an increase in fuel prices in June 2008. In mid 2008, headline inflation started to recede as food prices stopped rising, even as additional pressure remained from higher oil and commodity prices. The global slowdown led to a sudden reversal of oil and commodity prices. Looking ahead, inflation is likely to continue to decline and it may be very low in 2009. However, risks and uncertainties about future price developments are accentuated by the conduct of monetary and exchange rate policy, with monetary policy constrained by the limited flexibility in the exchange rate.

Figure 4 Industry Still Outpaces Services
(constant prices)



Source: NBS, World Bank staff estimates

Figure 5 Investment Still Outpaces Consumption
(constant prices)



Source: NBS, World Bank staff estimates

17. **A visible reflection of China's macroeconomic imbalances is the current account surplus, which climbed to over 11 percent of GDP in 2007, approaching 0.75 percent of global output.** The trade surplus declined in the first 5 months of 2008 from its level a year ago because of a large deterioration in the terms of trade as raw material prices soared. In constant prices, though, net external trade continued to contribute to GDP growth even as the world economy slowed. The large external surplus reflects the lack of progress in rebalancing the overall pattern of growth. Exchange rate developments have been an important factor limiting this progress, although, as noted, many elements of the policy setting have played a role, including the pricing of inputs and capital for industry, fiscal policy, and financial sector policies.

18. **China's exchange rate has gradually appreciated.** Since July 2005, the exchange rate of the RMB has been set with reference to a basket of currencies, and it has appreciated almost 21 percent against the U.S. dollar up to November 2008. The U.S. dollar, however, has depreciated against most of world's major currencies during this period, despite strengthening in recent months. As a result, on a trade-weighted basis, the RMB's appreciation has been more limited since July 2005, at 15 percent. At the same time, productivity growth in China's manufacturing industry has continued apace, implying a strengthening of the equilibrium exchange rate.

Optimization and Upgrading of Industrial Structure

19. **There is mixed progress in meeting the overall objectives in the area of industrial structure.** The targets on the share of total employment in the service sector and R&D are within reach. However, given recent trends, it seems unlikely that the target to raise the share of the service sector in GDP can be met. Instead, during the first three years of the 11th 5YP, industry continued to outpace the services industry. Within the industrial sector, energy-intensive heavy and chemical industries (such as steel and aluminum) gained further importance, even though they slowed considerably in late 2008. These developments have made achieving the objectives on energy efficiency and environmental quality more difficult to achieve.

20. **The industry-specific agenda to upgrade the industrial structure appears to be on track.** While it is difficult to measure progress in this area, the tasks the Government set on industrial upgrading are being carried out: accelerating the development of high tech industries; revitalizing equipment manufacturing industries; and adjusting the structure and spatial layout of raw materials industries. Industrial upgrading has involved a strong role for government in resource allocation, in the form of investment licensing, access to land and financial resources, and various administrative measures.

21. **Whether carrying out the industrial agenda actually improves the economic and industrial structure is open to question.** This is because it is difficult to assess whether setting and carrying out a detailed agenda for industrial structural changes yields optimality in an increasingly market-oriented economy. With the increased market orientation of China's economy, industrial upgrading is best pursued by measures that

encourage innovation such as improved IPR, venture capital markets, better governance of SOEs, and greater access of private firms to capital markets.

22. Overall quantitative indicators generally suggest continued improvements in the performance of the industrial sector. This is evident in the continued rapid growth in labor productivity and catch up with high income countries during the first two years of the 11th 5YP. The productivity improvements and upgrading boost China's international competitiveness. Judging from continued increases in China's global market share, this competitiveness position is strong. In addition, until the recent downturn measures of the return on capital have continued to improve for both SOEs and non-SOEs. However, SOEs continue to show considerably higher capital intensity (the amount of capital per worker), with lower rates of return on capital, employment creation and labor productivity growth than non-SOEs.

Increasing Energy Efficiency

23. China's energy intensity (the amount of energy per unit of output) has been reduced, but by much less than needed to achieve a 20 percent reduction by 2010. At the start of the 11th 5YP, energy intensity reversed an upward trend exhibited since 2002. However, the extent to which this can be sustained is questionable. This is because the reduction in energy intensity seems to be mainly at the sectoral rather than the macro level. At the sectoral level, higher energy efficiency has been achieved in specific products. However, capital-intensive and high energy using industries continue to grow more rapidly than other parts of the economy. That is because the overall pattern of growth and the policies underlying it, including the pricing of energy and other resources, remain broadly unchanged. Looking ahead, the efficiency gains from technical upgrading and closure of inefficient capacity will become harder to tap in the future. Without rebalancing the pattern of growth and the economic and industrial structure, it is unlikely that the 20 percent reduction target in energy intensity could be achieved. Raising energy prices would likely be most effective in promoting energy efficiency and contributes to rebalancing. It is equally important to put in place the policies and the institutional, regulatory, technical, and financial framework and capacity to sustain China's efforts to transform to more energy efficient economic growth.

Coordinated Urban and Rural Development and Improving Basic Public Services

24. The first two years of the 11th 5YP have witnessed substantial social progress. Government spending on rural issues is budgeted to increase from 1.6 percent of GDP in 2005 to 2.0 percent of GDP in 2008. Conditions in rural areas improved significantly. The targets on balanced rural-urban development in the 11th 5YP, including the coverage of the new rural cooperative medical services, farmland retention, and per capita income of rural residents, will likely be met (Table 3). Four policy initiatives helped to improve farmers' incomes and living conditions: (i) the abolishment of agricultural taxes and fees in 2005; (ii) introduction of free compulsory education in the countryside; (iii) the introduction of the rural cooperative medical insurance schemes; and (iv) the extension of the minimum living standard allowance.

Table 3 Social Indicators

	2005	2007	2010 target	Percent completed
Basic urban old age insurance contributors (millions)	175	201	223	54
No. of beneficiaries rural <i>dibao</i> (millions)	8.3	34.5
No. of counties with NCMS (percent) 1/	22	86	80 2/	> 100
No. of beneficiaries rural Medical Assistance(millions)	11.1	35.7

Source: MOLSS, Civil Affairs Yearbook, MOH, MOE.

1/ New Rural Cooperative Medical System (health insurance).

2/ The target was recently revised to 100 percent.

25. **Considerable progress has also been made to improve public services in the areas of social protection, education, and health.** This is based on strong government effort and significant progress in rolling out various initiatives. While there are still important design issues in need of reform, achieving the targets for the social objectives laid out in the 11th 5YP is on track, or even ahead of schedule in some cases:

- China is on track to meet the targets for expanding basic urban pensions, unemployment insurance, work injury insurance, maternity insurance, and rural *dibao* program (a poverty gap program for the poorest rural residents). Having achieved this impressive progress, attention can now focus on several design issues with the framework for social protection.
- The targets for health protection and major disease prevention and control are also being realized ahead of schedule. All counties nationwide are expected to be covered by the new rural cooperative medical system by end 2008. Basic medical insurance for urban residents and employees is also expanding rapidly. A medical assistance system now covers all rural counties; good progress is also being made on introducing medical assistance in urban areas. Building on this rapid expansion of health protection, the government could usefully turn to some design issues.
- In the priority areas of education, targets for expanding free compulsory education nationwide, as well as for scale and system development of vocational and higher education will be achieved ahead of schedule.

26. **At the same time, the challenge of how to distribute the benefits of rapid economic development more equitably remains.** This is because while conditions are improving in rural areas, they are improving even faster in urban areas. Despite a massive increase in financial support in rural areas, with central government spending on agriculture and rural areas rising by 75 percent during 2005-07, the gaps in income and quality of life between the urban and rural areas continue to widen.

Enhancing Sustainable Development

27. **Preliminary indications are that China has made progress toward a more resource efficient and environmentally sound economy.** The unrelenting increase in air

and water pollution discharges over the past decade appears to have been reversed during the past two years, indicating progress toward the target reduction of SO₂ and COD emissions by 10 percent during the 11th 5YP, although meeting the target may be difficult (Table 4). The share of industrial solid waste that is treated has been raised. The efficiency of water use in irrigation and the industrial value added per unit of water consumed have increased, but the reduction in water intensity in industry by 30 percent remains a difficult goal. Forest coverage has steadily expanded, although the timetable for reaching the 20 percent target may have been set back somewhat by the recent severe winter.

28. **Nevertheless, immense environmental challenges remain.** Air and water pollution in China still exceeds applicable standards in most areas. Freshwater withdrawals already exceed sustainable levels of both surface and underground resources, especially in North China. The forest cover remains far below the level needed to restore its environmental and ecological functions, even though a massive reforestation effort has been under way for nearly a decade. Prospects for continued progress in increasing resource efficiency, however, are clouded by the current economic structure, with concentration of industrial growth in resource intensive, high polluting industries.

Table 4 Environmental Indicators

	2005	2007	2010 target	Percent completed
COD emission (10000 ton)	1414	1384	1270	21
SO ₂ emission (10000 ton)	2549	2467	2295	32
Utilization of industrial solid waste (%)	56	61.2	1/ 60	> 100

Source: Statistical Yearbook 2007, Xinhua.

1/ Data for 2006.

29. **In sum, significant progress has been made toward many of the major objectives of the 11th 5YP, but important challenges remain.** In particular, insufficient progress on macroeconomic rebalancing and changing the economic and industrial structure has limited progress on energy and water intensity, and environmental quality. Also, with little progress in rebalancing, less urban job creation has occurred than could have been under a more labor intensive pattern of growth—in particular, less formal urban employment and permanent migration—potentially undermining the social progress that has been achieved. Moreover, the limited strengthening of the exchange rate, combined with rapid productivity growth, especially in manufacturing, has—combined with other elements of the policy setting that boost investment in industry—contributed to the large and unsustainable external current account surplus. Accordingly, priority should be given to rebalancing which would help to meet the environmental objectives and solidify the social gains.

The Policy Agenda Ahead

30. **Achieving a rebalanced economy requires reforms in a broad range of areas.** These encompass macroeconomic and structural policies, fiscal policy and intergovernmental fiscal relations, government spending, monitoring and evaluation,

administrative reforms, price reforms, and regulations and standards. The implementation experience thus far suggests the following areas for policy adjustments.

31. A range of macroeconomic and structural policies will help to stimulate domestic consumption, reduce domestic saving, and stimulate expansion of the services sector. These include:

- Continue to shift government spending from investment to social protection, health, and education.
- Strengthen further the exchange rate to shift production from tradables to non-tradables and increase exchange rate flexibility to give more independence to monetary policy; this, in turn, would facilitate greater reliance on market based instruments, including interest rates, for macroeconomic management.
- Further pursue financial market reforms to improve the efficiency in the allocation of capital, consistent with higher interest rates, thus keeping growth up with less investment and increasing the role of consumption. Such reform and more efficient allocation of capital should benefit the service sector and small and medium-sized enterprises.
- Expand the dividend policy for SOEs and improve corporate governance to remove the over-investment bias, especially in large, industrial SOEs.

32. Fiscal and tax policy can help to adjust the structure of production:

- Eliminate the underpricing of industrial inputs—land, energy, water, natural resources, and the environment—through price increases, tax measures, and/or pollution charges. Accelerated energy price reform would allow prices to reflect the full cost of supply, including environmental and depletion costs. The recent adjustment in domestic oil prices is a step in the right direction.
- Remove remaining distortions in the tax system that subsidizes manufacturing, including the VAT system as well as remaining preferential tax treatment of FDI.
- Remove remaining restrictions on the development of a thriving services industry. Addressing, as planned, monopolies and oligopolies in several service sectors is important, as is removing other barriers and vigorously implementing WTO commitments.

33. Introduce institutional reforms that give local officials stronger incentives and better tools to pursue rebalancing are also important. A key measure is to increase accountability, especially via the performance evaluation of local officials and enforcement of laws and regulations. Last year's measure to include land revenue in the local government budget, rather than as part of the extra-budgetary funds managed by

land bureaus, could improve the governance of these funds and reduce the incentive to pursue a land-intensive development pattern.

34. **China is in a strong fiscal position to support the rebalancing of the economy.** Fiscal savings from higher energy and resource prices and environmental taxes could be used for expenditures in priority areas identified by the 11th 5YP, reductions in other taxes, or compensation to vulnerable groups affected by the price adjustments.

35. **Reform of the intergovernmental fiscal relations would allow poor regions to have the resources to carry out improvements in the social sectors.** Inadequate local funding (and capacity) in poor regions is a serious constraint on further progress in many areas, including the delivery of rural services, social protection, education, health, and resource efficiency. Sub-national governments in China are responsible for a much larger share of spending than in most other countries. In the absence of significant net transfers from rich to poor regions or other revenue sources, large disparities in spending per person on public services are unavoidable. Moreover, income-poor but resource-rich provinces are currently not adequately compensated when their resources are extracted for national development. Reform of the intergovernmental fiscal system is required to fundamentally address the problem. Such reform would need to include higher net transfers via the center from rich regions to poor regions, notably through higher equalization grants, possibly combined with further changes in spending responsibilities between sub-national governments and the center. In addition, China should consider options for devolving more revenue sources that benefit poor regions. Higher resource taxes provide an opportunity to grant the poor provinces higher tax shares and make the poor provinces less dependent on fiscal transfers. Payments for environmental services (such as water, land conversion rights) could become revenue for the poor provinces as well.

36. **Increased government spending puts a premium on the efficiency of spending.** The recent increase in spending and introduction of many new initiatives call for more systematic and rigorous monitoring and evaluation frameworks.

37. This involves more research and analysis to develop better monitoring indicators, focusing on results and quality, drawing on international experience and benchmarks; and developing a robust information system to track progress. More can be done to nurture a culture of evidence-based evaluation and building capacity for it. There needs to be better linkage between results of evaluations and adjustments in policies, priorities, and financing. In addition, stronger accountability is required, and the recent move to expand the local officials' evaluation system to include objectives of the 11th 5YP should be helpful in this regard. Fragmentation of various programs, while probably unavoidable in a big country like China, calls for further efforts at consolidation and coordination.

38. **To close the rural-urban income gap, a dual approach is needed that fosters both a reallocation of labor from rural to urban areas and increases rural labor productivity on and off the farm.** While restrictions on the migration of rural labor to urban areas can be further relaxed, this in itself cannot be done fast enough to effectively

close the rural-urban income gap. Nor can urban-rural income transfers fully close the gap. This suggests the need for increases in agricultural output and productivity which, in turn, requires more, but also more efficient public spending on rural public goods. More spending could be directed to agricultural science and technology; environmentally sustainable techniques for staple crop production (including more efficient water management); and agricultural diversification to high value products. Further efforts are also needed to create an enabling environment for agricultural modernization by deepening and speeding up land related reforms, including land acquisition and land tenure rights, and improving agricultural producers' access to financial services.

39. **Administrative tools need to be augmented by increased reliance on market incentives and regulatory means.** So far, rapid progress has been achieved through administrative measures in the areas of energy efficiency and environmental pollution. However, this rate of progress may be difficult to sustain in the future without greater reliance on market incentives and the regulatory system, including the criteria used for performance evaluation of local government officials. There is increasing urgency in building a policy and institutional framework that uses market-based instruments to encourage rebalancing. Price reforms are called for, especially in the areas of energy and resources pricing and taxation, but China's grain price policies may also need to be adjusted to bring domestic prices closer to international ones. Regulatory measures could include environmental emission standards, consumer products labeling, and fuel and building efficiency standards. Vigorous enforcement of regulations and standards will, of course, be equally important.