July 1992

170

World Bank Discussion Papers
China and Mongolia Department Series

A Chinese Province as a Reform Experiment:

The Case of Hainan

Paul M. Cadario
Kazuko Ogawa
Yin-Kann Wen

Public Disclosure Authorized

Recent World Bank Discussion Papers

No. 110 *Social Security in Latin America: Issues and Options for the World Bank*. William McGreevey

No. 111 *Household Consequences of High Fertility in Pakistan*. Susan Cochrane, Valerie Kozel, and Harold Alderman

No. 112 *Strengthening Protection of Intellectual Property in Developing Countries: A Survey of the Literature*. Wolfgang Siebeck, editor, with Robert E. Evenson, William Lesser, and Carlos A. Primo Braga

No. 113 *World Bank Lending for Small and Medium Enterprises*. Leila Webster

No. 114 *Using Knowledge from Social Science in Development Projects*. Michael M. Cernea

No. 115 *Designing Major Policy Reform: Lessons from the Transport Sector*. Ian G. Heggie

No. 116 *Women's Work, Education, and Family Welfare in Peru*. Barbara K. Herz and Shahidur R. Khandker, editors

No. 117 *Developing Financial Institutions for the Poor and Reducing Barriers to Access for Women*. Sharon L. Holt and Helena Ribe

No. 118 *Improving the Performance of Soviet Enterprises*. John Nellis

No. 119 *Public Enterprise Reform: Lessons from the Past and Issues for the Future*. Ahmed Galal

No. 120 *The Information Technology Revolution and Economic Development*. Nagy K. Hanna

No. 121 *Promoting Rural Cooperatives in Developing Countries: The Case of Sub-Saharan Africa*. Avishay Braverman, J. Luis Guasch, Monika Huppi, and Lorenz Pohlmeier

No. 122 *Performance Evaluation for Public Enterprises*. Leroy P. Jones

No. 123 *Urban Housing Reform in China: An Economic Analysis*. George S. Tolley

No. 124 *The New Fiscal Federalism in Brazil*. Anwar Shah

No. 125 *Housing Reform in Socialist Economies*. Bertrand Renaud

No. 126 *Agricultural Technology in Sub-Saharan Africa: A Workshop on Research Issues*. Suzanne Gnaegy and Jock R. Anderson, editors

No. 127 *Using Indigenous Knowledge in Agricultural Development*. D. Michael Warren

No. 128 *Research on Irrigation and Drainage Technologies: Fifteen Years of World Bank Experience*. Raed Safadi and Hervé Plusquellec

No. 129 *Rent Control in Developing Countries*. Stephen Malpezzi and Gwendolyn Ball

No. 130 *Patterns of Direct Foreign Investment in China*. Zafar Shah Khan

No. 131 *A New View of Economic Growth: Four Lectures*. Maurice FG. Scott

No. 132 *Adjusting Educational Policies: Conserving Resources While Raising School Quality*. Bruce Fuller and Aklilu Habte, editors

No. 133 *Letting Girls Learn: Promising Approaches in Primary and Secondary Education*. Barbara Herz, K. Subbarao, Masooma Habib, and Laura Raney

No. 134 *Forest Economics and Policy Analysis: An Overview*. William F. Hyde and David H. Newman, with a contribution by Roger A. Sedjo

No. 135 *A Strategy for Fisheries Development*. Eduardo Loayza, in collaboration with Lucian M. Sprague

No. 136 *Strengthening Public Service Accountability: A Conceptual Framework*. Samuel Paul

No. 137 *Deferred Cost Recovery for Higher Education: Student Loan Programs in Developing Countries*. Douglas Albrecht and Adrian Ziderman

(Continued on the inside back cover.)

A Chinese Province as a Reform Experiment:

The Case of Hainan

China and Mongolia Department Series

Patterns of Direct Foreign Investment in China, Zafar Shah Khan, September 1991

Coal Pricing in China: Issues and Reform Strategies, Yves Albouy, October 1991

Reforming Prices: The Experience of China, Hungary, and Poland, Anand Rajaram, January 1992

Developing Mongolia, Shahid Yusuf and Shahid Javed Burki, January 1992

Sino-Japanese Economic Relationships: Trade, Direct Investment, and Future Strategy, Shuichi Ono, January 1992

The Sectoral Foundations of China's Development. Shahid Javed Burki and Shahid Yusuf, editors, January 1992

Transport Development in Southern China. Clell G. Harral, editor, and Peter Cook and Edward Holland, principal contributors, February 1992

Rural Enterprise Development in China. Anthony J. Ody, May 1992

170

World Bank Discussion Papers
China and Mongolia Department Series

A Chinese Province as a Reform Experiment:

The Case of Hainan

Paul M. Cadario
Kazuko Ogawa
Yin-Kann Wen

The World Bank
Washington, D.C.

Manufactured in the United States of America
First printing July 1992

The complete backlist of publications from the World Bank is shown in the annual *Index of Publications,* which contains an alphabetical title list (with full ordering information) and indexes of subjects, authors, and countries and regions. The latest edition is available free of charge from the Distribution Unit, Office of the Publisher, Department F, The World Bank, 1818 H Street, N.W., Washington, D.C. 20433, U.S.A., or from Publications, The World Bank, 66, avenue d'Iéna, 75116 Paris, France.

ISSN: 0259-210X

Paul M. Cadario is principal country officer and Kazuko Ogawa is an economist in the Country Department II of the World Bank's East Asia and Pacific Regional Office. Yin-Kann Wen is senior economist in the National Economic Management Division of the Bank's Economic Development Institute.

Library of Congress Cataloging-in-Publication Data

Cadario, Paul M.
A Chinese province as a reform experiment : the case of Hainan / Paul M. Cadario, Kazuko Ogawa, and Yin-Kann Wen.
p. cm.—(World Bank discussion papers ; 170)
ISBN 0-8213-2169-2
1. Investments, Foreign—China—Hainan Province. 2. Joint ventures—China—Hainan Province. 3. Mixed economy—China—Hainan Province. 4. Hainan Province (China)—Economic policy. 5. Hainan Province (China)—Economic conditions. I. Ogawa, Kazuko. II. Wen, Yin-Kahn, 1943– III. Title. IV. Series.
HG5782.C33 1992
338.951'29—dc20 92-19133
CIP

FOREWORD

The World Bank's economic and sector work program in China is a very active one, ranging over a wide spectrum of topics from macroeconomics to health and education. Each year we publish a handful of our formal studies, but thus far most of the background papers and informal reports, many of them containing valuable analysis and information, have remained outside the public domain. Through the China and Mongolia Department Working Paper Series, we hope to make available to a broad readership among China watchers and development communities a few of the papers which can contribute to a better understanding of China's modernization.

The study by Mr. Cadario, Ms. Ogawa and Mr. Wen of provincial development in Hainan reviews the context of and prospects for China's only Special Economic Zone that covers an entire province. When Hainan became a province in 1988, the central government wanted to make it a special zone that would go far beyond even the other SEZs in system reform. It was to have a "small government and large society," implying very little state-operated enterprise and minimal government. Despite its essential backwardness, pockets of absolute poverty, inadequate infrastructure and other difficulties, Hainan has made progress in economic development, attracting investment from both the mainland and overseas. Its economy, previously dominated by state-owned rubber and iron ore industries, has diversified through substantial growth in services and small-scale enterprise, including export-oriented joint ventures. However, the pace of reform and investment slowed during the national austerity program from early 1989 to late 1991, calling into question the ambitiousness of some of Hainan's plans to lead the way in reform experiments in agriculture, industry and human resource development. Recently, though, the reform agenda seems to have regained momentum, as Hainan deals in greater depth with the trade, investment and fiscal modernization that could propel it into prosperity.

This limited, policy-oriented study of Hainan's prospects for achieving export-oriented growth, drawing on materials prepared by researchers in Hainan and abroad, was undertaken at the request of the provincial government. It not only analyzes Hainan's experience to mid-1991, but also suggests ways in which the province's reform agenda might be accelerated as the next key steps are identified and opportunities seized by both Beijing and Haikou.

Shahid Javed Burki
Director
China and Mongolia Department
East Asia and Pacific Region

CURRENCY EQUIVALENTS

Currency Unit = Yuan (Y)

Before December 15, 1989	To November 16, 1990	Effective November 17, 1990
$1.00 = Y 3.72	$1.00 = Y 4.72	$1.00 = Y 5.22
Y 1.00 = $0.27	Y 1.00 = $0.21	Y 1.00 = $0.19

FISCAL YEAR

January 1 - December 31

WEIGHT AND MEASURES

Metric system unless otherwise noted

ACRONYMS

ABC	-	Agricultural Bank of China
BFT	-	Bureau of Finance and Taxation
CASS	-	Chinese Academy of Social Sciences
CG	-	Central Government
CNOOC	-	China National Offshore Oil Corporation
DFI	-	Direct Foreign Investment
DFT	-	Department of Finance and Taxation
FEC	-	Foreign Exchange Certificate
FIE	-	Foreign Investment Enterprise
GDP	-	Gross Domestic Product
GVIAO	-	Gross Value of Industrial and Agricultural Output
HPG	-	Hainan Provincial Government
HSY	-	Hainan Statistical Yearbook
ICT	-	Industrial and Commercial Tax
JICA	-	Japan International Cooperation Agency
LNG	-	Liquified Natural Gas
MOF	-	Ministry of Finance
MOFERT	-	Ministry of Foreign Economic Relations and Trade
PBC	-	People's Bank of China
PIP	-	Public Investment Program
RCC	-	Rural Credit Cooperative
SAEC	-	State Administration for Exchange Control
SEZ	-	Special Economic Zone
SPC	-	State Planning Commission
TIC	-	Trust and Investment Company
TVE	-	Township and Village Enterprise
UCC	-	Urban Credit Cooperative
WBLAO	-	World Bank Loan Administration Office
WOV	-	(Foreign) Wholly-Owned Venture

PREFACE

i. Located in the South China Sea off the southwest coast of (and formerly part of) Guangdong Province, Hainan is a tropical island with a population of 6.5 million. In early 1988, it was designated both a province and a Special Economic Zone (SEZ), the latter status permitting it to offer foreign investors an attractive package including tax exemptions and duty free status for production inputs. In addition, Beijing declared its intention to make Hainan a special area that would go beyond the other SEZs and become a "laboratory for system reform." It was to have a "small government and large society," implying little state-operated enterprise and minimal detailed government intervention in the economy. More specifically, the island was permitted to offer investors land-use rights on a leasehold basis for up to 70 years, to operate a free market in foreign exchange, and in general to function primarily by market principles, with no discrimination among enterprises on the basis of their ownership.

ii. In many ways the island is richly endowed with natural resources, some of them unique or rare within China. But past comparative neglect has left it until recently relatively underdeveloped, and with pockets of absolute poverty. Stimulating domestic and foreign private sector activity holds the promise to make more efficient use of the province's comparative advantage and to improve the livelihood of its population, as well as that of increasing numbers of migrants from the mainland. Beyond this, Hainan has the potential--as both local and national officials have emphasized--to serve as a testing ground for many of the comprehensive, market-based reforms whose implementation throughout China is planned over the medium term.

iii. Today, Hainan's economy has three prominent features: 19 cities and counties that present a mixture of urban and rural, state-owned enterprise (SOE) and township and village enterprise (TVE) activities and (relative) poverty and (relative) affluence similar to much of southern, coastal China; an outward-oriented sector with some foreign investment in joint ventures, mainly for assembly and tourism, but so far dominated mainly by domestic trading companies motivated by advantageous foreign exchange retention opportunities; and, a state farm sector producing rubber and other tropical crops. The challenge is to shape this current structure to suit its future goals using the latitude permitted by the reform laboratory concept, while mitigating the hardships of the transition in ways that would make Hainan's experience a model for the rest of China.

iv. It was against this background that the Hainan authorities approached the World Bank in late 1989 with a request for substantial long-term financial and technical assistance. As one of China's five SEZs (which the Bank has not so far studied) and, since mid-1989, a so-called laboratory for reform, Beijing's ambitious goals for Hainan merited renewed interest from at least these two perspectives. In the circumstances and given the availability of three recent studies of the province--by the Japanese International Cooperation Agency (JICA) in 1986/87, by the Chinese Academy of Social Sciences in early 1988, and by the RAND Corporation in 1989/90--this limited,

policy-oriented study of Hainan's prospects for market-oriented development, drawing heavily on these materials, was undertaken.

v. A market economy in Hainan would have two benefits: first, to develop the island's resources and thereby stimulate employment and prosperity there, and, second, to serve as as a testing ground for "the planned socialist commodity economy with Chinese characteristics," through a series of reform experiments. As Chapter 2 indicates, a fundamental issue is the demonstration value of these experiments for other areas of Hainan, and their applicability to other parts of China. On paper, Hainan's climate for investment is quite attractive and very similar to that in other SEZs. But there appear to be practical obstacles to encouraging foreign investment and even investment from the mainland. As Chapters 3 and 4 describe, some are erected by central ministries in Beijing, through their control over China's trade and investment approval process. Others can be tackled through simplified provincial procedures and as officials gain experience with the requirements of the market economy and how best to encourage prospective foreign investors. Hainan needs to eliminate barriers to foreign and domestic productive investment in the province, by making its investment climate and banking system transparent and predictable, and quite different from the mainland. An important signal would be an early start on the Yangpu Development Area, and relative autonomy to the developer to make the needed infrastructure investment and sell leases. Competition from foreign-owned enterprises would also be the best way to encourage international levels of quality and productivity for industrial products that Hainan's (and China's) SOEs wish to produce, whether for export or the domestic market.

vi. The "soft" environment for investment is not sufficient: Hainan will also need to continue to establish the basic transport, energy and urban infrastructure needed to remove the real sector constraints. The status of the productive projects listed in Hainan's Eighth Five-Year Plan is unclear: whether they are indicative for foreign investor interest or whether they are priorities that must be met ahead of others. In 1988 Hainan's leaders envisaged a limited role for government in the productive sectors. As Chapter 4 argues, even in a market-oriented economy, the public sector plays the predominant role in infrastructure investment. Hainan's infrastructure is not at the level in Shenzhen or China's other SEZs that have had a nearly 10-year headstart. But infrastructure is not so deficient that it would be a serious barrier to suitable investment from abroad or from the mainland. To retrieve it own decision-making autonomy, Hainan may wish to be in the vanguard of moving to a different planning system, based on a new relationship between government and the productive sectors. It may wish to move to a more flexible and periodically updated public investment program, where priorities are revised in light of achievements and resources and the evolving needs of the local economy.

vii. In its reflections over the role of government in the province, Hainan has also considered some administrative reforms that might accompany the market-oriented economy. In addition to examining what government should do, and how, Hainan may wish to take action on several other fronts. It might examine its approach toward creating new offices and bureaus, an observed practice since Hainan became a province, with the risk of further expanding the public payroll. It might examine the rationale and desirability of the

province taking up partnerships with foreign investors, with uncertain risk to the government. The main instrument for reform is the decontrol of prices and markets, in a secure transparent and predictable legal and regulatory framework.

viii. As Chapter 5 indicates, Hainan now relies on generous central government financial support to cover recurrent deficits and its capital investment program. With expected private sector growth, Hainan may wish to simplify its tax system and broaden the tax base. Even with new revenue sources, the issue of how much additional revenue Hainan needs for its reform and development cannot be separated from the issue of how existing public resources are mobilized and spent. A full public expenditure review could examine these issues and the priorities for public sector outlays. Consistent with China's efforts to further national financial sector reforms and integrate the country's financial markets, Hainan's banking sector should remain independent of provincial government control and subject to national monetary policy.

ix. To address these priorities, Hainan will have to see that its civil servants and those in Beijing operate according to the rules envisaged in the State Council documents establishing the province. Being an island with provincial status could give Hainan certain freedom. But it also leads to real sector constraints that would have to be removed before policies to promote investment and trade will have the desired impact. This may require a wider field of provincial power than Hainan currently seems to enjoy.

A CHINESE PROVINCE AS A REFORM EXPERIMENT: THE CASE OF HAINAN

Table of Contents

This report is based on a mission to China in November 1990 by Paul Cadario (Principal Country Officer, Task Manager, EA2CO), Kazuko Ogawa (EA2CO) and Yin-Kann Wen (EDIEM), Economists. The mission's work was greatly helped by a Chinese counterpart team led by Wang Gang, Assistant to the Governor for Financial Affairs, Hainan Province. It included Chen Feng, Chi Fulin, Liao Xun, Zhang Chonglei, Deng Yingtao and Tan Xingdong. Jiang Hei, David Zhuang and Wang Xiaohua ably provided interpretation and translation of this report, a draft of which was discussed with the Hainan and central governments in July 1991. Charles Wolf and K. C. Yeh of the Rand Corporation (Santa Monica, California) and Rosa Lee of Hong Kong China Services, Ltd. (Hong Kong) also gave comments on the mission's work. Anthony Ody (EA2CO), N. Kay Hill (EA2AG) and Peter Harrold (EA2CO) provided other inputs. The report draws upon background material from studies prepared by The Japanese International Cooperation Agency (JICA) in 1986/87, the Chinese Academy of Social Sciences in early 1988, and the RAND Corporation in 1989/90.

Page No.

BOXES IN TEXT

TABLES IN TEXT

BACKGROUND PAPERS

1. "Investigation and Studies Report of the World Bank Loan for Hainan's Regional Development" (World Bank Loan Administration Office, Hainan Provincial Government, July 1990).
2. "The Report on the Eighth Five-Year Plan and Ten-Year Plan for National Economic and Social Development of Hainan Province" (Governor Liu Jianfeng).
3. "Continue with Deepened Reform and Open Further to the Outside World--Preliminary Ideas for Hainan's Economic Restructuring Plan During the Eighth Five-Year Plan Period" (Hainan Provincial Government, 1991).
4. "Key Areas of System Reform in the Province for 1991" (Hainan Provincial Government, 1991).
5. "Program for Reforming the Grain Purchasing and Marketing System of Hainan Province" (Hainan Provincial Government, 1991)
6. "Financial Model Envisaged for Hainan" (People's Bank of China, Hainan Branch).

I. HAINAN--AN OVERVIEW

1.1 Located strategically in the South China Sea off the southwest coast (and formerly part of) Guangdong Province, Hainan is a tropical island which, at 34,000 km^2, is slightly smaller than Taiwan Province. Its annual per capita income in 1988 was estimated at about Y 1,000 ($270), about 85 percent of the national average ($320), but there are wide variations. Monthly industrial workforce incomes are estimated to range from Y 400 - Y 1,600 (1989) in Haikou while annual per capita incomes in some Li and Miao minority villages are reportedly as low as Y 200. Hainan's exports in 1989 totaled $360.8 million, (less than 1 percent of China's total), of which about one-third originated within Hainan, while the balance were re-exports from mainland provinces. The majority of domestic exports came from the agriculture and mining sectors.

1.2 An open area since 1983, in early 1988, Hainan was designated both a province and a Special Economic Zone (SEZ). The latter status allowed it to offer foreign investors an attractive package of tax exemptions, duty free status for production inputs, etc. In addition, Beijing declared its intention to make Hainan a special area that would go beyond the other SEZs in system reform. It was to have a "small government and large society," implying minimal detailed government intervention in the economy and few state-operated enterprises. More specifically, the island was to be permitted to offer investors land-use rights on a leasehold basis for up to 70 years, to operate a free market in foreign exchange, and in general to function primarily by market principles, with no discrimination among enterprises on the basis of their ownership status.

1.3 Development of Hainan along market principles and creating a more open environment thorugh reform would have two sets of benefits. The island is in many ways quite richly endowed with natural resources, some of them unique or rare within China, but its past comparative neglect has left it until recently relatively underdeveloped, and with pockets of absolute poverty. Stimulating domestic and foreign private sector activity and relying on market regulation holds the promise to make more efficient use of the province's comparative advantage and to improve the livelihood of its existing population, as well as that of increasing numbers of migrants from the mainland. Beyond this, Hainan has the potential--as both local and national officials have emphasized--to serve as a testing ground for many of the comprehensive, market-based reforms whose implementation throughout China is planned over the medium term. The challenges of reform will exert pressures on Hainan's people. The authorities' success at mitigating the hardships of transition will also offer models for elsewhere in China.

1.4 Agriculture, which accounts for 62 percent of Hainan's GDP, is the mainstay of Hainan's economy. Growth during the post-1979 reform period averaged 10.8 percent per annum, exceeding that on the mainland before 1985 (14.2 percent per annum compared to 8.1 percent) but falling back to about the national average since then. While the main crops are plantation rubber, smallholder rice paddies and vegetable plots, growth in the last decade has been concentrated in commercial crops--coffee and tea, bananas, pepper, sugar, cane, and tropical medical herbs--that are not subject to official procure-

ment. Output of agricultural township and village enterprises (TVEs) processing agricultural products grew at an average annual rate of more than 15 percent. Extensive monoculture rubber plantations cover about 25 percent of the island's area and produce 65 percent of China's total production (para. 2.16). Hainan's small stands of original diptocarp forests appear to offer little potential for commercial forestry and now cover only 3 percent of the island's land area, compared to 30 percent in 1950 (before rubber development began). Food industries are dominated by sugarcane processing. Hainan also has substantial aquaculture possibilities, potentially 19,000 ha suitable for shrimp, crab and shellfish breeding and seaweed production, as well as 47,000 ha of fresh water suitable for fisheries. Offshore fish resources have not yet been measured but, given concerns about the resources off Guangdong and the sustainable catch, would need careful study before any large expansion in the fleet or rate of fishing in waters off Hainan.

1.5 Land Use and Ecology. The reduction in Hainan's natural forest coverage has driven 15 animal species and 76 plant species, among the latter a plant from which anticancer agents can be extracted, to the verge of extinction. Soil erosion from rubber plantation development and slash-and-burn cultivation has also increased, causing frequent micro-droughts and mountain floods. Overfishing, destruction of coastal coral and wetlands, and urban industrial and household wastes may have already damaged the regenerative capacity of important species of fish and other marine life. Following a 1988 central government directive that special care should be taken to preserve and enhance its unique environment, Hainan is elaborating a policy for the province's environmental protection. An international conference in March 1990 established an International Advisory Council to stimulate international cooperation in the sustainable development of Hainan. To allow integration of environmental concerns with Hainan's economic development plans, HPG has obtained funding from the Asian Development Bank to prepare a master plan for environment and natural resource management. While most investment projects in Hainan have had satisfactory environmental impact assessments, the plan seeks to establish comprehensive environmental policies for sound management of the island's natural resources.

1.6 Industry is less developed, accounting for only 16 percent of provincial income and employing only 7 percent of the labor force. Limited central government investment in the pre-reform period was concentrated mainly in rubber and iron ore. More than 70 percent of industrial output comes from state-owned enterprises (SOEs), mainly mining of high quality iron ore. Hainan's industry has developed rapidly since the mid-1980s: 1989 total industrial investment was Y 288 million, compared to Y 261 million during the entire Sixth Five-Year Plan, of which SOE investment accounted for over 75 percent. Expanded investment has led to a dramatic increase in the value of industrial production, with annual real growth of 16.5 percent from 1980 to 1988. Despite the continued dominance of the state-owned sector, there has been a gradual shift in production value from the state-owned to collective/other sectors (83:17 in 1981 to 71:29 in 1988), and since 1988, a small but growing number of companies have been financed by direct foreign investment. From virtually none in 1979, nearly 90,000 TVEs and private service operations had been established by the end of 1988, employing 262,800 staff and with total revenues of Y 1.45 billion.

1.7 Mineral Resources. China's best iron ore reserves (averaging 63 percent hematite (Fe_2O_3), with few impurities) are at the Changjiang Shilu ("Shilu") mine. The mine and a 52 km dedicated railway to an iron ore port at Basuo, established by the Japanese during the 1930s, are operated by the Hainan Iron Ore Company. Reserves are estimated at 380 million tons. Annual production at the open pit mine fluctuates around 4 million tons, almost all of which is shipped to 72 iron and steel plants on the mainland at prices set by the State Planning Commission. The company operates at near capacity, selling its output at unit prices (Y 40.7/mt) which have been unchanged for several years.1/ Titanium is found in seashore sand deposits on the southeast coast, estimated to contain about 12 million tons. It can be mined open cast, and the average grade of concentrated ore after magnetic separation is 50-52 percent TiO_2. There are eight deposits of limestone totaling 240 million tons and three of silicon sand (300 million tons). Zirconium and copper are also produced and shipped to the mainland after basic treatment. A geological survey has been proposed to explore Hainan's mineral resources in greater detail.

1.8 Energy Resources. Total hydroelectric power potential is estimated at 995 MW, 75 percent of it on the Nandu, Changhua, and Wanquan Rivers. The Asian Development Bank is financing a water resources study of the northern half of the island. The largest potential is the Daguangba Project on the Changhua River, an investment that has already been started with partial World Bank financing. There are two coal mines producing low grade coal (2,500-3,600 kcal/kg), but the likelihood of finding further deposits worth exploiting is very small. Natural gas reserves have been located about 100 km off Hainan's south coast. Their extent is still being explored by a joint venture of ARCO and China National Offshore Oil Corporation, and proven reserves are estimated at 3.6 TCF. Exploitation of the reserves for gas export, fertilizer, and cement and glass production and power generation in Hainan will depend on the outcome of ongoing negotiations between ARCO, CNOOC, and potential Hong Kong buyers of the natural gas. The small exploitable capacity of the Beibu Bay oil reserves (estimated at 500 million tons) does not justify development at present oil prices and, citing investment climate difficulties, the foreign partner has withdrawn from exploration activities. Hainan's tropical location might permit small-scale solar power applications, but cloud cover during the monsoon season would restrict any large-scale use.

1.9 Tourism has received extensive attention since Hainan was designated an open area in 1983. The JICA Study concluded that there were 5 sites offering attractions to foreign tourists and 37 which tourists would visit once they were in Hainan. The main attractions, centered on Sanya in the south, are nature sites and beaches,2/ although wetlands and forest conservation concerns would need to be addressed in any large-scale development. In 1989, about 110,000 foreign tourists visited Hainan, most of them from Taiwan, Hong Kong, and Macau, leaving about $11.5 million in foreign exchange. There are

---

1/ For reference, recent prices for Australian iron ore of comparable quality, c.i.f. Japan, were approximately $31.50/mt (Y 164/mt).

2/ The beach at Yalong Bay, near Sanya, has been called "the Chinese Hawaii."

foreign joint venture hotels in Haikou and Sanya, but the main international hotel chains have not yet invested in Hainan.

1.10 Human Resources. Hainan's population has grown from 3 to over 6 million over the last three decades, and may reach 10 million by the year 2000 if present migration patterns from the mainland continue. Although the granting of provincial status led to applications from 200,000 professional and skilled workers from the mainland to migrate to Hainan, the province still faces a shortage of skilled labor.3/ School enrollment ratios in Hainan in 1990 were slightly higher than in the rest of China: 98.3 percent of primary school age children, 74 percent of middle school age, and 44 percent of high school age. Over 20 percent of high school graduates enter universities and other post-secondary institutions, many to places at mainland schools the State Education Commission allocates for Hainan. With more flexible labor markets and the closing of many TVEs on the mainland during the recent austerity program, particularly in poor areas of Yunnan, Guangxi, and Guangdong (which also have Li and Miao minorities), many workers have come to Hainan to find employment in construction and services. Hainan's two main cities, Haikou and Sanya, have grown rapidly in the past few years.

1.11 The provincial government is also concerned with the poverty issue, predominantly found among areas inhabited by minority nationals and in remote mountainous areas. Of the 720,000 living in such areas, HPG estimates there are approximately 120,000 people living in unacceptable conditions. In order to alleviate poverty, HPG has drawn up a program with the following timetable. The Eighth Five-Year Plan period will aim at improving the living conditions for the poor; during the first three years of the plan period, it is hoped the poor will attain a per capita income level of Y 300-400 and will be able to have adequate food and clothing; during the remaining two years, a further income increase to Y 500-600 will be the target, thus consolidating earlier gains. During the Ninth Five-Year Plan period (1996-2000), emphasis will be on guiding the poverty areas to growth and prosperity so that the per capita income can catch up with the rest of the province. HPG notes that for this to be successful, supporting infrastructure and social services need to be expanded in the poverty areas. In addition, given local resource endowments, development should focus on the primary sector and processing industries using local resources.

1.12 Hainan's development remains substantially behind other areas of southern coastal China. Despite its SEZ status and respectable levels of foreign investment, it has not yet attracted high inflows; despite significant potential for rubber and tropical crops, agriculture and related industries are still basic; and its traditional farming has much lower yields than in the Pearl River Delta. Some argue that this results from the "colonial policy" of the mainland toward the island in the pre-reform period: as an outpost of national defence and a source of domestic rubber production developed after the US-led embargoes of the early 1950s, Hainan did not attract significant investment in nonagricultural activities. Even after China's reforms began,

---

3/ After its enthusiastic launch in early 1988, Hainan's labor market potential for skilled labor cooled, and many potential migrants did not, in fact, come.

the central government's limited support for infrastructure development in the province, unlike in the other SEZs that started a decade earlier, made Hainan's lag in industry and infrastructure difficult to overcome.

Table 1.1: HAINAN: BASIC STATISTICS

	1978	1980	1985	1986	1987	1988	1989	1990
Population (thousand)	5,284.5	5,525.3	5,975.1	6,056.3	6,150.8	6,274.9	6,387.9	6,512.3
Provincial income (Y million)	1,326	1,517	3,571	3,943	4,552	6,208	7,230	7,800
of which, agriculture	727	907	2,089	2,420	2,794	3,870	4,351	4,638
industry	292	284	614	639	729	983	1,181	1,350
construction	68	72	321	311	311	416	667	765
transport & communications	66	59	135	156	226	236	271	281
commerce	173	195	412	417	492	703	760	766
Provincial income (Share to total %)	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
of which, agriculture	54.8%	59.8%	58.5%	61.4%	61.4%	62.3%	60.2%	59.5%
industry	22.0%	18.7%	17.2%	16.2%	16.0%	15.8%	16.3%	17.3%
construction	5.1%	4.7%	9.0%	7.9%	6.8%	6.7%	9.2%	9.8%
transport & communications	5.0%	3.9%	3.8%	4.0%	5.0%	3.8%	3.7%	3.6%
commerce	13.0%	12.9%	11.5%	10.6%	10.8%	11.3%	10.5%	9.8%
Provincial income index		100.00	181.69	195.51	216.67	237.92	250.33	
Gross Domestic Product (Y Million)			4,226.00	4,673.00	5,588.00	7,475.92	8,686.75	9,400.00
Per capita provincial income (Y)	251	275	598	651	740	989	1,132	1,198
Per capita GDP (Y)					908	1,191	1,360	1,443
Fiscal revenue as % of provincial income	10.28	7.83	8.85	6.57	6.50	7.77	8.65	9.47
Fiscal expenditure as % of provincial income	12.59	13.84	16.52	16.82	14.77	14.90	19.10	22.33
Fiscal expenditure: % for capital construction	5.62	5.65	23.06	11.71	6.98	13.57	17.89	19.98
Fiscal expenditure: % for cult. educ. science	33.69	36.18	28.59	32.68	33.22	30.82	26.14	25.61
Fiscal expenditure: % for administration	15.44	18.55	15.07	15.89	17.69	11.87	10.43	

Sources: Hainan Statistical Yearbook 1990 (HSY90), pp. 622-623 for 1980-89; p. 66 for 1978/79.
Other items, see other tables and Hainan Statistical Yearbook 1989 (HSY89).

II. REFORMS IN HAINAN--PROGRESS AND POTENTIAL

2.1 In September 1987, the Central Committee and the State Council established three broad directions for reform in the new province: a market economy, rather than the "planned commodity economy"; equal competition between economic units, irrespective of ownership, rather than "public ownership as key"; and "small government, big society," rather than government organization mirroring the central government ministries.1/ Because of the province's small market, the authorities chose an outward-oriented economy as their goal. They also hoped that reforms in Hainan would resolve dilemmas China will face in a future phase of comprehensive system reforms on the mainland. This chapter sketches out how this reform orientation has proceeded so far, the problems encountered, and the challenges still to be met.

2.2 Development Strategy.2/ Hainan's stated long-term goal is to reach the income level of the developed regions of China. This would be achieved by transforming its current, agriculturally-oriented economy into one based on modern light industry and services, oriented to export since the island's own markets are limited. The means for this transformation would be "comprehensive system reform," described and commented upon more fully below. Its main elements are as follows. A combination of land use planning and changes in land taxation, with rural cooperatives organized along lines practiced in some experimental areas on the mainland, would encourage higher value uses and promote urbanization, while maintenance of current tariffs would protect domestic rubber production against more efficient foreign competition.3/ Enterprise reforms would improve the competitiveness of existing urban state enterprises, which would be expanded and increasingly oriented to exports of agricultural and natural gas-based products. Social security, health insurance and housing reform would facilitate enterprise reforms and promote social stability during this transformation. Fiscal, trade, and banking reforms would decrease Hainan's reliance on central export and fiscal controls and take full advantage of SEZ legislation. While direct foreign investment would be aggressively encouraged, Hainan hopes to borrow from concessional lenders, with State guarantees, to finance at least some of the infrastructure needed.4/

1/ *Xiao Zhengfu, Da Shehui* (State Council Document 26).

2/ "Investigation and Studies Report of the World Bank Loan for Hainan's Regional Development." Hainan Provincial Government, World Bank Loan Administration Office, July 1990 (WBLAO).

3/ But any cost advantage from these imports to domestic users is fully offset by the current level of import tariff.

4/ For 1991, the Provincial Conference of System Reform held in March 1991 has identified the following ten items as its areas of focus in system reform: grain procurement and marketing; social security; perfecting the market system; enterprise reform; perfecting the system of "small government and large society"; county-level comprehensive reform; state asset management; housing; labor and wage policy; and personnel policy.

2.3 This strategy has merit, but it does not necessarily reflect the island's current level of development, or its financial and human resource constraints. Moreover, in establishing its investment priorities, Hainan needs to take into account the province's comparative advantage and the economic cost of exploiting it.

A. The Rural Sector

2.4 As noted elsewhere in this report, agricultural activities continue to account for the bulk of Hainan's GDP and employment, as well as the majority, by value, of exports generated within Hainan. In addition, rural enterprises in industry and services--whether communally or privately owned--have proved a dynamic sector in recent years in the province, as elsewhere in China. The report's examination of policy issues in the rural sector will divide it into two subsectors:

(a) the staple grain subsector, largely producing rice under irrigated (padi) conditions, much of which is procured under contract arrangements at controlled prices; and

(b) the commercial production subsector, producing and often processing an increasing variety of higher value crops, livestock and aquaculture products, under essentially free market conditions, for both domestic and export consumers.

The State Farm system, under central management from the Bureau of State Farms in the Ministry of Agriculture in Beijing, and largely oriented to the production of rubber for the mainland is described in Section B, on the organization of the public sector.

2.5 Staple Foodgrains. The growing of irrigated rice on Hainan commenced during the 1930s, and by 1988 the area cultivated amounted to almost half a million hectares. In spite of this expansion, however, the island remains heavily dependent upon imports to meet its own food requirements (the deficit amounted to about 400,000 mt per annum in the late 1980s). Indeed the area sown to grain had peaked in 1975, since when increases in average yields, still relatively low by mainland standards, roughly offset the impact of declining area planted on overall production. Studies by the provincial government point to the physical decay of irrigation facilities during the 1980s, a phenomenon also noted in many parts of the mainland. However, they also recognize that low official procurement prices for foodgrains had made unit returns to labor (or land) unattractive compared to cash crops and non-agricultural employment. Enforcing compulsory procurement quotas is reported to have become a major problem for local officials, while farmers are said to try to limit grain output to meeting their own consumption demands, and to seek to evade the official quotas.

2.6 The above problems are far from unique to Hainan, and indeed characterize the grain sector throughout China.5/ As in Hainan, the perceived need to guarantee the supply of subsidized grain to registered urban dwellers

---

5/ China: Managing an Agricultural Transformation (October 17, 1990).

is responsible for both extensive explicit subsidies (reflected in fiscal accounts) and the imposition of implicit taxation on farmers through compulsory grain procurement at below-market prices. This is an area in which policy reforms within Hainan could potentially offer a long-term example to the rest of the country. Planning studies by HPG recognize the advantages to be gained by completing the liberalization of agricultural procurement. If farmers faced market prices for grain, as they already do for almost all other crops, their production decisions would accurately reflect comparative advantage and be more economically efficient. It would also be possible for official agencies to withdraw progressively from their present involvement in grain procurement, allowing this responsibility to be assumed by commercial bodies. As a first step, Hainan revised its grain pricing policy on May 1, 1991, the same day as the nationwide grain pricing reform was implemented. While the latter consisted of a Y 0.2 increase per jin (approximately one pound) at the retail level, Hainan's reform had the following additional characteristics: (a) grain prices in Hainan were allowed to float within a margin of plus of minus 5 percent while the rest of China was still subject to unified state pricing; (b) the procurement price, as well as the urban retail price, was raised; (c) the margin on price increase at the retail level was larger in Hainan than on the mainland, resulting in a narrower gap between the procurement and retail prices for Hainan than elsewhere (the operating costs for delivery and warehousing will, however, still have to be covered by subsidies); and given the larger increase in the retail price, the compensatory wage increase was Y 10 per month in contrast to Y 6 for the rest of China.

2.7 In addition, the provincial authorities should initiate preparatory activities in the following areas:

(a) If in-kind subsidies to consumers are to be replaced by explicit cash payments,6/ HPG needs to devise improved targeting mechanisms, so that the truly needy consumers are provided for.

(b) Steps should be taken to convert existing distribution agencies into commercial bodies, fully responsible for financial profit and loss; and

(c) At present, the compulsory grain procurement constitutes probably the principal implicit means of taxing agriculture, though there is

---

6/ In early 1990, the monthly allocation of grain per urban resident was reduced from 25 to 20 catties. About 2 million urban residents (staff of institutes and administrative units, military forces and their families), students and vegetable growers are eligible. The provincial government has announced plans to eliminate general consumers subsidies on grain and edible oils during 1991 and shift to targeted subsidies with a one-time wage adjustment.

a host of other charges.7/ Prior to phasing it out, HPG should prepare to introduce an alternative, less-distortionary and more broad-based system of agricultural taxation. There is widespread agreement on the economic merit of taxing agricultural land, based on its assessed production value. A land tax based on a properly conducted, systematic land survey could potentially replace most or all of the numerous charges farmers currently face, as well as the indirect taxation grain procurement quotas impose. Such a tax does not distort production choices among alternative uses (though it does discourage holding productive land idle). Once an initial survey has been accomplished, subsequent administration is fairly straightforward. However, the initial survey is a demanding exercise and therefore preparations should be begun without delay. Whether State Farm land could also be brought into the tax base would depend on the outcome of the broader dialogue advocated below (para. 2.18).

2.8 In parallel with the above measures, HPG may also wish to revisit the issue of deteriorating irrigation facilities. Different levels of government throughout China have found it difficult to maintain earlier levels of budgetary expenditure on water conservation. At the same time, the enthusiasm of farmers for either providing in-kind labor inputs for maintenance of facilities or paying water charges has typically been compromised by the heavy implicit taxation of the grain sector. If Hainan can lead the way in liberalizing the procurement and pricing of foodstuffs, it should also be well-placed to pioneer more effective systems of user-charges to finance the rehabilitation of its network of irrigation infrastructure. It may wish to privatize maintenance activities and their funding.

2.9 Commercial Crop Subsector. As in the rest of China, the decade since the introduction of the production responsibility system has seen farmers in Hainan taking advantage of their new freedom of decision-making to diversify production into a wide range of higher valued commercial products. Hainan's tropical climate has permitted it to expand output of a range of crops not widely grown elsewhere in the country. Agricultural growth has thus been largely concentrated in such market segments as coffee, tea, bananas, pepper, and tropical medical herbs, which are not subject to official procurement. The same period also saw complementary expansion in agricultural township and village enterprises (TVEs) engaged in processing activities, at an average annual rate of 15 percent. Available data suggest that Hainan has fostered the growth of TVEs by maintaining relatively low average rates of taxation. HPG has also affirmed its policy of facilitating the establishment

---

7/ Agricultural tax, contract grain procurement, special agricultural and forest product tax, land (crops) contract fee, fee for allowance for survivors of revolutionary martyrs and servicemen, living expenses of the "five guarantees" households, salaries of village cadres, salaries of minban teachers, channels and ditches maintenance fees, fee for irrigation management personnel costs, fee for establishment of schools, building maintenance fee, fees for road maintenance, building of bridges and water towers, well digging, expenses for power supply facilities, and charges for collective traditional activities.

of new individually or privately owned TVEs through simple and straightforward registration processes, and it appears that "other" enterprises (i.e. neither SOEs nor collectives) have been easily the most dynamic element in the industrial sector since in the mid-1980s.

2.10 Overall, the commercial crop subsector, with its related processing activities, appears in its recent dynamism to bear witness to the success of the market-oriented environment which policies have created. There is one crop which seems to provide an exception to this picture, however. The processing of sugarcane is undertaken by a number of provincially controlled SOEs, generally among the largest such enterprises. It is understood that these firms, between them, account for a significant proportion of the total financial deficits of the provincial SOE sector. HPG needs to assess the extent to which such losses are either intrinsic or reflect remediable industrial or agricultural inefficiencies, or existing pricing arrangements for sugar sales to the mainland. The province's objective should be to arrive at a considered strategy for placing its sugar industry, possibly after selective mill closures or restructuring, on a sound financial and economic basis.

2.11 More generally, the province should pursue policies which recognize the strong continued economic potential of the commercial cropping, livestock and aquaculture subsector and seek to support and facilitate predominantly private sector endeavors to realize this potential. Official support should be concentrated on relieving those bottlenecks which the private sector, by itself, may be unable to resolve, rather than duplicating private efforts. Such areas are likely to include:

(a) Provision of strengthened research and development programs on new crops and extension of research results to potential or actual producers;

(b) Provision of a clear and equitable legal framework for rural economic activities, including continued openness to registration of new enterprises and the delineation and protection of land use rights;

(c) Representing the rights of Hainan to equitable access to export quotas (see also chapter 3);

(d) Establishing a system of regulation of financial institutions (including rural and urban credit cooperatives) which combines freedom of entry with appropriate prudential banking standards (Hainan may wish to experiment with financial system reforms along these lines);

(e) Dissemination of market information to producers, particularly regarding opportunities on the mainland and in international markets; and

(f) Promotion and facilitation of foreign joint ventures in production, processing and marketing, on mutually equitable terms.

A program of support along the above lines will call for some redirection of earlier activities, and significant efforts at institutional development.

2.12 HPG has recently proposed a somewhat more directed and geographically concentrated approach to promoting commercial development in rural areas. The province has formulated proposals for rural reform experiments to develop tropical crops and improve their marketing prospects. The experiment proposals have four common elements: creation of voluntary, nonprofit farmer cooperatives; preferential policies to attract investment to the experimental areas; land use controls to "stipulate the basic behavior of land owners, users and explorers"; and personnel training for market-oriented occupations. These experiments would be carried out in six areas, with three proposed for implementation with overseas support during the Eighth Five-Year Plan (1991-95). The goal of these experiments is to encourage tropical crop development, aquaculture and agroprocessing on lands most suitable for export-oriented agriculture. But the rationale for establishing "leading" and "nonleading" areas is not clear. The three proposals (Box 2.1), and several others not planned for immediate implementation, appropriately focus on market-oriented activities responding to price signals and particularly overseas markets. Subject to confirmation, they also allow the possibility of taking advantage of existing specialized households (e.g., for melon and fruit transport and marketing). Financial organizations for long-term credit could support these activities. However, the proposals have several troubling features: apparent reliance on existing state-owned enterprises to lead the demonstration; the implication that geographic monopsonies are to be permitted and administrative measures should be used to limit the number of nonprofit farmer cooperatives and for-profit farmer companies to be created; imposition of controls on land use; lack of market research on the sales prospects for the targeted products; and the concentration of what appear to be largely government-led activities (presumably with investment of government funds) and government "guidance" to the rural financial organizations. The prospects for integration of different types of production activities in the selected areas, one of the stated goals, are also not clear.

2.13 As suggested in Box 2.1, the technical economic and financial merits of the specific investments proposed require further, more detailed assessment. More fundamentally, it is not clear that they incorporate institutional models or a policy design that will establish an appropriate basis for replication elsewhere in Hainan or on the mainland. Launching demonstrations without market research appears imprudent, and the emphasis on public sector involvement seems to go against the trend of commercialization and private sector development. It is also paradoxical that experimental areas with special regulations are to be established "making the preferential policies in Hainan SEZ legal, authoritative and mandatory, ...on a trial basis" in a province where these policies nominally already apply throughout.

2.14 Owing to the traditional free use of land, new provincial regulations concerning land rents and land transfer procedures and fees have not been consistently implemented. While the provincial government intends to use its monopoly power to grant land leases to investors, it does not propose, it appears, to allow a market for high quality land. However, transfer of "second rate" land, once it has been developed, will be permitted. Indeed, a prominent feature of the reforms under consideration, the proposed Administer-

Box 2.1: EVALUATION OF PROPOSED INVESTMENTS TO SUPPORT AGRICULTURAL REFORM EXPERIMENTS

1. Ledong County (13,300 ha of off-season, high value vegetables). The area is in the rain shadow of the central mountain range, the driest part of the island. Unlike the eastern part, it is protected from typhoons. Annual crops can be grown without supplemental irrigation only from April to October: irrigation works proposed would permit high value cool season crops to be grown for export. The list proposed is long, and would need to be reviewed and focused on high-value, off-season vegetables for areas to which marketing does not face export quotas unless they can be removed (i.e., Japan and Taiwan rather than Hong Kong and Macao). The proposal includes purchase of a second-hand refrigerated ship, but lacks discussion of organization, management, and marketing issues and alternative, more practical transport arrangements. The project might be a good candidate for a joint venture with a foreign company with access to latest vegetable growing and processing technology and superior vegetable varieties for the export markets.

2. Dongfang County (13,330 ha of fruit). Trials have shown that the area is well-suited for mango, litchi, longan, and cashew production. As most of the fruits are seasonal, it would be essential to evaluate not only the market prospects but also the processing facilities to ensure optimum production patterns. The proposal also includes a factory producing an unspecified pesticide, and establishment of a fruit research institute. Again, marketing, management, and organizational issues, and the relationship to Hainan's four agricultural research centers, are not discussed.

3. Rural Forestry (2,000 ha) and two Paper Mills (50,000 mtpy capacity). As the project area is on the eastern side of the island, which is prone to typhoons, the wind-resistance of eucalyptus spp. and Pinus caribaea would need to be confirmed. Discharge of effluent from the paper plants would need to be carefully checked and the latest environmental standards for effluent disposal (not discussed) would need to be incorporated into the paper plant investment, which accounts for 84 percent of the cost of the proposed activity. In absence of discussion of organization, management and implementation procedures, claimed poverty focus of forestry component difficult to justify. Paper plants, if economically and financially justified and environmentally appropriate, might be candidates for nonstate investment.

ing Committee for the Experimental Areas, gives cause for concern about the overall orientation of the government's policies. With broad powers of planning, examination and approval, the Administering Committee would mandate, and therefore effectively supersede, land use and planning permissions from provincial departments, whose views are merely to be sought on activities to be undertaken. There would be subsidiary Administering Committees at the county levels. The rationale for this layered organizational structure is not clear, nor will the special treatment the selected reform areas would obtain from provincial bodies necessarily be replicated as quick and transparent treatment involvement for others seeking approval for similar activities. The government committee would oversee three dependent bodies: (a) "the Bank of Land," a "large-scale enterprise of public ownership founded by the Hainan Provincial Government," that will determine land lease and land prices, market land, and provide mortgages; (b) a wholesale market for trading of agricultural products; and, (c) an Information Center. The Bank of Land's powers and responsibilities need some rethinking: it is not generally appropriate, for example, for a financial institution to make loans on the basis of its own determination of land lease and asset values, or to operate, as is proposed, outside normal financial system supervision. The proposed exemption of the bank from income tax would also give it a distinct advantage over its competitors who, in a market-oriented banking system, should be able to take up similar functions and compete for customers. The proposal for the whole-

sale market is less detailed, but it would be appropriate to examine organizational models based on private farmer cooperatives (production, transport and marketing), with less emphasis on approval and registration by a government agency, regulation of prices, etc. A specific but separate approach to modernizing existing government marketing channels and opening them up to competition with private cooperatives would be desirable, as would integration with reforms of input marketing. The Information Center's proposed duties seem to combine investment promotion with market intelligence. It needs to be asked whether those functions might be better performed by the provincial government itself for the whole province, using existing bodies such as the Investment Promotion Committee, appropriately streamlined and reinforced.

B. The Government Sector and Public Enterprises

2.15 Administrative Reform. The consolidation of the Hainan Administrative Region, including the minority Autonomous Region and the Hainan counties previously part of Guangdong Province, into a single provincial administration with local governments reduced the number of "*ting*"-("office") level institutions in the island from 64 to 27. However, staff in administration were reduced by a mere 200. Nineteen of the abolished government units became provincial enterprises and holding companies, and 800 civil servants became their employees. Since 1988, five new "*ting*" have been created--four of them to deal with central government ministries, who effectively insisted on direct, provincial counterparts; and a fifth, to handle prospective World Bank lending to the province. Hainan's local governments are still modelled on the old, central government structure at the county and prefecture level. The civil service in the province has expanded by about 5,000 (3.2 percent) since 1988. Hainan has also created a basic legal system. But legal practitioners are few and the court system is only rudimentary, with little case law on, or experience with legal methods/procedures for enforcement and litigation. An Anti-Corruption Office was set up under the Provincial People's Prosecutor's Office in October 1990, but is not yet fully staffed.

2.16 State Farms. The State Farms system constitutes the largest single economic sector in Hainan.8/ Its establishment dates from the 1950s, when China's rapidly growing need for rubber, in the face of the then-prevailing international embargo, prompted an extensive import-substitution program by way of the large-scale resettlement of mainlanders on "reclamation farms". The farms continue to be primarily dedicated to monoculture rubber production, and their plantations cover 360,000 hectares and in 1988 produced 156,500 mt, or 65 percent of China's total production. Output is sold through state channels at controlled prices (Y 7.0 per kg in 1990) which have generally been somewhat higher than world market equivalents (about US$ 1.0 per kg). Since 1987, however, Hainan's rubber output has been declining, partly due to heavy

---

8/ In 1989, the 92 State Farms accounted for 51.5 percent of Hainan's total employment of SOEs and 16.3 percent of the total labor force. This system accounted for almost 25 percent of gross value of industrial and agricultural output (Y 1.3 billion out of Y 5.3 billion in 1989), 39 percent of total agricultural output (Y 1.1 billion out of Y 2.7 billion), and 9 percent of total industrial output (0.2 billion out of Y 2.5 billion).

typhoon damage to about one third of the plantations in 1989, but partly because the farms have been finding commercial crops and livestock products more attractive in financial terms. The State Farms operate almost entirely independently of the Hainan Provincial Government. Their investments are approved by and financed from the central Bureau, and any profits or deficits are also handled internally within the State Farm system. Similarly, the State Farms provide all social services to their residents: the farms pay no taxes to HPG. Under present arrangements, therefore, it is the central government which must confront the decisions needed on the strategic future of the sector.

2.17 At issue is the long-term competitiveness of State Farm production of rubber in Hainan. A definitive view on the issue cannot be taken on the basis of the data made available. Causes for concern include apparently low levels of labor productivity and physical yields per hectare, by international standards, and the sector's vulnerability to frequent typhoon damage, as well as the producer price paid above international levels, and the recent trend towards diversification into other crops: it is not known how many of the farms currently record financial surpluses or deficits. The farms have recently made proposals for replanting and expanding production during the 1990s, which the center will need to evaluate. It will be well-advised to view the sector as much as possible against commercial criteria: i.e., regarding each farm as a potential cost and profit center which should be expected to borrow for development purposes at prevailing rates, and valuing its output at projected international prices. Some "sunk costs," such as accrued pension rights, may need to be written off. But for the future, attention must be given to the ability of the sector to compete against southeast Asian producers which show higher yields due to new varieties and superior management. The relevant agencies and researchers need to investigate the potential to introduce new, higher-yielding clones to Hainan; to improve labor productivity through better payment-by-results systems; and also to see that, in future, timber value is fully exploited in plantation management. Should the economic future of rubber production in Hainan appear reasonably certain, it might even be appropriate to evaluate locating some of China's rubber-using industries in Hainan, provided energy requirements and transport to final mainland users and overseas clients could be organized.

2.18 At the same time, as noted previously, doubts do exist as to rubber's long-term viability. The original strategic imperative for forced import-substitution, regardless of cost, no longer applies. If the center can now consider the farms as economic decision-making units, each responsible for its financial results, rather than as centrally-directed "production units," whose financial viability is secondary, it should be prepared to accept the consequence if some of the farms continue to find diversification out of rubber into other lines of production to provide higher financial returns, and should facilitate that transition. The center should also start to reconsider the long-term justification for maintaining the farms as centrally-directed enclaves separate from the mainstream provincial economy, and could in time invite HPG to open a dialogue on the issues involved in integrating the State Farms into the regular provincial administration.

2.19 <u>State-Owned Enterprises in Hainan's Economy</u>. Although the province has determined that SOEs should be responsible for their own profits and

losses, they are still a heavy burden, accounting in 1989 for Y 95 million of subsidies, about 15 percent of the province's budget. The enterprise reform principles outlined in the province's reform documents have still not clearly distinguished between profits and taxes (despite the reported separation of taxes from profits in tax accounting), or recognized the need for enterprises to retain earnings to finance expansion or as reserves. When the portion in Hainan's economy resulting from the central government-controlled state farms and iron ore sector is excluded, SOEs account for only about 19 percent of provincial production. Hainan's size and the strong performance of the foreign venture, TVE and nonstate small enterprise sectors thus give it distinct advantages in pursuing enterprise reform experiments that might be applicable elsewhere in China. SOE reform in China is desirable for two reasons: the misallocation of real resources that results from the incentives offered by distorted prices and managerial decisions according to nonmarket signals; and the heavy budgetary burden--about one-quarter of government revenues in Hainan's case--that they impose. The SOE reform implications to Hainan from these two separate characteristics of public enterprise behavior are different, but both touch on the role of government in a province which is to take the lead in establishing prices as the main force for resource allocation. In defining next steps for reform, Hainan should give enterprise reform a high priority.

2.20 After attempting to hold 1990 public expenditures on SOE and grain price subsidies to their 1989 levels, the provincial government has indicated its intention to eliminate general consumer subsidies for grain during 1991 (para. 2.6). This is a bold and important start. However, Hainan may wish in addition to review its overall philosophy and approach to government involvement in production, and take advantage of its experimental, reform status to investigate new approaches. In the area of grain subsidies, for example, deregulation of producer prices for rice might encourage farmers to expand production, thus helping meet more of the demand of Hainan's growing urban population from domestic supply. If, as suggested above, this were accompanied by full cost-recovery for irrigation and other rural production infrastructure (which might continue to benefit from efficient government support for renovation and, selectively, expansion), this would remove price distortions in the rural sector and allow savings in subsidies to be redirected. While some of the savings on consumer subsidies for staple food will likely be needed for targeted support to the poor and disadvantaged groups in the population, the rest--likely around three-quarters 9/--could be directed for other purposes. In cities and towns, TVE and private ventures have expanded dramatically, now providing (as elsewhere in much of south China) services and petty commerce to meet a widening range of consumer needs, as well as the requirements of the building and small construction sectors. Hainan may, therefore, wish to investigate whether continued state involvement in these activities is warranted, or whether it could, over a relatively short period, shift the management and ultimately the ownership of these firms into the collective or private sector. Free of direct government control, these units

---

9/ If one were to assume, for example, that only those Hainan residents in counties meeting the State Council's definition of poverty would receive food subsidies, through a program of targeted income support, the dependent population would fall from the current 2.1 million to about 400,000.

could then compete with firms that have sprung up in response to the market environment already so dominant in much of the province's economic life. The provincial government's intentions concerning the promotion of private activities in agriculture and small-scale enterprise would then be clear.

2.21 A first step for Hainan would be to prepare full management and financial audits of all enterprises owned by the public sector, including commercial and industrial companies as well as the public utilities. Reform of accounting and audit practices, now under consideration by the central government, could be piloted in Hainan as the basis for this effort. One possibility would be to assign this task to the State Assets Administration unit in the province's Bureau of Finance and Taxation (BFT) responsible for state-owned assets (though short-term outside professional support could speed the process). Making this unit solely responsible for government oversight of SOEs would remove any tendency for existing commercial and industrial bureaus to continue to involve themselves in the management and operation of the enterprises, by basing the relationship of the latter to the government solely on financial criteria, measured by normal balance sheet information, prepared according to generally accepted accounting principles. This rigorous evaluation of SOEs' financial positions and performance (including monitoring of any declining subsidies against agreed targets) would set the stage for auctioning some enterprises (as HPG has boldly proposed) or issuing shares in new joint stock companies. It would also in the first instance allow BFT, as the owner's representative, to agree on ex ante performance targets to be met by the companies, and full elimination of enterprise subsidies. International experience has amply proven that changes in ownership are rarely successful by themselves in turning around unsuccessful companies. Eventually, bankruptcy and liquidation of the unsuccessful ones that cannot operate profitably in the marketplace will prove necessary. But a new approach in Hainan to the government's ownership role would allow HPG to redirect its industrial and commercial bureaus to a regulatory and policy function, suitable to a market-oriented economy, rather than the directive role they now play in the day-to-day management of enterprises. This process of changing the bureaus' role and reducing their staffs to play it effectively would offer useful experience to other parts of China wishing to deal with companies similar in size and vocation to those found in Hainan.

2.22 The sale of loss-making enterprises is seen as a way to eliminate the authorities' annual subsidy burden, while capital market development, including a provincial stock market, would allow trading of shares and eventual mobilization of new capital. The feasibility of this approach would depend inter alia on the performance and prospects of the companies on asset valuation, on the extent of post-divestiture government regulation, and on the social responsibilities expected of new owners. Moreover, arrangements also need to be worked out for structuring and managing the state's "portfolio" of shares in divested companies. The province's approach to acquiring interests in new or privatized enterprises and joint ventures (if such participation is compatible with a market-oriented economy, as it may well not be) also needs to be defined. More broadly, Hainan may wish to expand its access to national capital resources by having shares of its companies listed on other Chinese stock exchanges, and thereby mobilize portfolio investment across provincial boundaries.

C. Labor, Social Security, and the Safety Net

2.23 Labor Market Reforms. The labor contract system has been in effect in Hainan since 1983. This has led to the beginning of a labor market with worker mobility and market-determined wages for the part of the urban labor force employed in the joint-venture sector in the suburbs of Haikou, and in the collective and TVE sector throughout the island. The authorities acknowledge that, in the market economy Hainan desires, "the individual has the right to select his occupation and to migrate to seek employment, for consumption as a consumer, and for investment and development of industry as a property owner." They propose that wages be determined without reference to levels and grades in the public sector, and that various nonwage income such as housing or food subsidies should be monetized. A process of negotiation is implicit in this process, either individually or through collective bargaining, and the right to choose one's occupation also assumes some competition among employers based on wages and fringe benefits. The provincial government has hinted that bargaining and trade unions or employee groups independent of government are to be encouraged, but there are no indications that this will take place soon. Nonetheless, the emerging sense of acquisitiveness and self-interest among Hainan's workers could, in freely functioning, competitive employment markets, stimulate increased labor productivity and efficient wage determination. However, enterprise reform and the discipline of a hard budget constraint (and bankruptcy) would be needed to ensure that SOE and nonstate company managers alike offer worker compensation linked to firm productivity, output, and profitability.

2.24 The provincial government has correctly realized that labor market incentives and enterprise reforms will also require alternative social security guarantees for Hainan's workforce and their dependents. This need arises because, as elsewhere in China, pension and unemployment benefits, health insurance, and housing are now the responsibility of individual enterprises. As long as these benefits are tied to a specific employer, workers will be reluctant to abandon their status as SOE permanent workers, compelled to compete for jobs. It will be difficult for managers to hire unskilled or less skilled labor at lower cost so as not to fall behind other farms in productivity. Moreover, as in other parts of China following the reforms, the social welfare benefits that have replaced the "cradle to grave" system provided earlier by the production brigades cover only a small percentage of the province's workforce and population. Hainan therefore intends to develop pluralistic social assistance and income security systems. In addition to replacing employer-run systems that tie workers to specific work units and thus hinder development of competitive labor markets, these new systems would also protect the elderly, the sick and the disabled.

2.25 In line with these general principles, in late 1989, the State Council authorized experiments in social security reform in Hainan. The province has accordingly begun to replace the current, employer-based system of pension, unemployment and social security benefits with one operated by the government, that also provides for workers' contributions. This will facilitate labor mobility, remove a major cost and administrative burden to new, nonstate companies, and, if the system is well-designed and efficiently run, streamline the administrative burden for all employers. As a new system, however, it has not yet built up financial reserves from premiums to guarantee payments to

meet the needs the systems were set up to cover. The first challenge will be to extend government-organized social security to cover all urban workers, whose numbers may grow rapidly in the future and whose mobility will make portable, individualized social benefits important. While the farm population has not enjoyed unemployment and pension coverage, a challenge will be to provide financing at least for rural health care, which used to be provided by the rural communes.

2.26 Pensions. By 1989, 1,805 state-owned enterprises (just over 80 percent), employing 116,300 workers, 65 percent of the urban permanent workforce, were taking part in preparations for a full-scale provincial pension system. Enterprises pay premiums based on payroll, with two contribution rates based on whether the company has retirees or not. Workers also contribute about 20 percent of their wage. In 1989, 31,700 workers received pensions from this new system, assuring them monthly payments of about Y 86 or about two-thirds of the per capita basic urban wage. Hainan's old age security system also covers 57,600 contract workers in 4,069 enterprises, some 90 percent of the contract workers outside the reclamation farm system. Temporary workers can also participate, but only about 20 percent are now covered. All 484,400 state farm workers are covered by pensions as well. As the population ages, an actuarially-based system of contributions and pensions will need to be devised and implemented. The province intends to put in place a fairly classical social security model, relying on joint employer/employee premiums on a standard schedule, and paid to workers on retirement from the workforce. Benefits should be paid for the life of a retiree, with premiums set on an actuarial basis to cover them; however, published descriptions of the system, which seem to anticipate a worker "running out" of a publicly-operated pension before his death, with "family members encouraged to provide relief to them," imply that its actuarial and funding basis has not yet been fully developed.

2.27 Medical insurance (Box 2.2) is now enjoyed only by urban workers under two separate systems, one for the 159,000 state and state-enterprise employees and their families, and a second for 526,000 fixed, contract and temporary workers and their families. Farmers and the unemployed, who used to be covered under the commune system, make private arrangements for medical care. The government's intention is "to establish a medical treatment insurance system with socialized management, which could guarantee medical treatment to all patients and reduce the expenses of medical treatment to a minimum." These two objectives are not necessarily linked, as the issue of cost-effectiveness of the health system (private and public) is not fully dependent on the insurance mechanism established. Medical treatment is provided to state employees by public health services operated by the state and labor insurance medical units run by enterprises under three payment arrangements.

2.28 The government has proposed to eliminate employer responsibility for medical insurance, and replace it with an individual account covering lifetime medical costs other than those related to occupational injuries. The system would be funded by employer contributions and general government revenues, and treatment costs would involve some payment by the beneficiary. However, the insurance features of the system are not clear, since it is proposed that "when the worker has run out of his own accumulated premium, he can get some pay from the social medical relief funds." Once this inconsistency is sorted out, the financial implications of charging all workers premiums and making government the insurer (since it runs most of the health services) with some

Box 2.2: MEDICAL INSURANCE IN HAINAN

Health facilities serving about 15 percent of the insured population receive funding for state employees' health costs, averaging Y 172 per capita annually. These service providers can keep any surplus in their budgets but will be "compensated for reasonable overspending." Health care funds are also allocated to SOE employers, who can keep any surplus but must bear any overspending themselves. This is much like self-insured medical insurance plans operated by many large employers in developed countries without government health care systems supported by public budgets. About 60 percent of the insured are covered by this employer-based system. About 25 percent of the insured follow a third system: outpatient services are managed by employers, while hospital costs are controlled by the public health services. Patients make low copayments (workers pay the most, 10 percent of outpatient costs and 5 percent of hospital costs), subject to a maximum annual expense of Y 120. State enterprises set aside five percent of their total wage bill for the medical expenses of contract, fixed, and temporary workers but the financial results and actual cost-sharing are unclear from available data.

copay arrangement should be examined, and reviewed against equity and coverage criteria.

2.29 Unemployment Insurance and Workers' Compensation. By the end of 1989, unemployment insurance covered 280,000 workers in state-run enterprises. Coverage is far from complete, excluding workers in the rubber farms, township and village enterprises, joint ventures and private companies. Without expanding premium collection, it will be impossible to assure a reasonable replacement rate for the current annual urban wage of Y 1,640. About 228,000 workers in 520 work units are covered for loss of income as a result of industrial injuries. Premiums, set at 1 percent of the workers' total monthly wages, finance an insurance fund. Established only in 1989, its reserves are small even though the needs are potentially substantial as private sector employment expands and increases in premiums are planned. It is not clear, however, that unemployment premiums and benefits in Hainan need be larger than in other SEZs, where market forces, and thus unemployment potential, are also well established. The government proposes that once unemployment benefits entitlements are exhausted, social relief support at a lower level would be provided.

2.30 Housing. Consistent with its desire to monetize fringe benefits now paid to public sector employees, Hainan plans to shift housing away from provision by enterprises and employers. However, these plans are not yet developed beyond the recognition that property rights should be transferred to the individual and that, ultimately, the housing market should be an important component of financial market development. Housing has become an important burden on government expenditure, nearly doubling in 1990 to Y 35.2 million or about 10 percent of public capital expenditure. Private rental housing has been developed in the industrial zone near Haikou and in other parts of the city, but the operation of the housing market and the occupancy rates are unclear. The province has not yet begun to develop programs for housing reform.

III. FOREIGN INVESTMENT AND TRADE

3.1 Hainan's establishment as an SEZ in 1988 represented a decision to make the island a focus for the attraction of foreign investment and for the generation of exports. This chapter will review the incentive policies which apply to foreign investment and trade, the degree of success achieved in their promotion to date and the remaining constraints and policy issues to be addressed.

A. Incentive Structures

3.2 Like the other SEZs, Hainan has been authorized by the center to offer foreign investors exemptions and holidays from corporate income tax. Foreign businesses are also permitted to remit their foreign exchange profits from the province in full. They may acquire long-term leasehold rights to land use: up to 70 years, a longer period than in the other SEZs. Visa authorization procedures for their foreign employees are somewhat easier than those for other SEZs. Hainan also apparently differs in its ability to offer investment incentives across a broader range of sectors (including not only agriculture and tourism, but even public utilities).

3.3 In addition, businesses operating within Hainan, whether foreign or Chinese, benefit from regulations on trade taxation and foreign exchange retention which have been consistently more liberal than those prevailing in the rest of China. Hainan may import articles for provincial consumption at 50 percent of China's national tariff. Imports to be used as inputs for production by foreign and mainland investors are duty free. If the article is to be further transshipped to the mainland, however, China's normal tariff is to apply, for which purpose the control and supervision of the customs authorities play an important role.

3.4 As regards the retention of foreign exchange earnings in hard currency, Hainan as a province enjoyed the right to 100 percent retention until January 1991. This right had also applied to the other four SEZs up to January 1990, since when they were required to submit 20 percent of foreign exchange earnings to Beijing. This arrangement stood in marked contrast to the situation in areas outside the SEZs, where--with some sectoral exceptions--75 percent of export earnings within Plan (mandated) export targets had to be submitted to the center, with 20 percent of "above quota" earnings.1/ Within Hainan, foreign invested enterprises (FIEs) themselves retain all their export earnings in hard currency, while domestic firms are required to sell from 4 percent (for industrial products) to 10 percent (for agricultural exports) to the provincial government in return for domestic currency. While some domestic enterprises are required to market their exports through

---

1/ Since January 1991, a new foreign exchange system has been put in place which differentiates the retention rates by product categories in contrast to the earlier system which differentiated retention rates by regions. It is reported that the new policy no longer gives favorable treatment to SEZs, but the implementation aspect of the policy is not yet clear.

official foreign trade corporations (FTCs), companies with at least 25 percent foreign ownership automatically acquire direct export rights for goods they produce themselves.

3.5 As elsewhere in China, Foreign Exchange Adjustment Centers (FEACs) operate in Hainan, at which foreign currency may be exchanged for renminbi at market determined rates. In view of the importance of free convertibility to foreign investors, as well as to the efficient operation of a market economy, some emphasis has been placed on the principle of free and unimpeded access to the FEACs in Hainan.

B. Performance: Foreign Investment

3.6 While foreign investment may take a variety of forms, including e.g., financial investment in foreign equities, in practice it is direct foreign investment (DFI) which is both most sensitive to the incentive schemes discussed above and of greatest quantitative relevance in the case of Hainan. DFI in the province increased from four contracts signed in 1980 to a peak of 463 contracts in 1988. In 1989, this dropped to 378, reflecting the impact both of the June 4 events on foreign investor behavior and of the tight credit situation due to the retrenchment policy. Of the three forms of DFI in China (Box 3.1)--equity joint venture (EJV), cooperative operations (CJV) and wholly-owned ventures (WOV)--the CJV was the prevalent form in the earlier years. All four contracts signed in 1980, and 47 out of 85 in 1985 took this form. There were only 4 WOV operations until 1987, but in 1988 this jumped to 138, and in 1989 to 165, mirroring the nationwide trend, after April 1986 central government legislation authorizing WOVs.

Box 3.1: DIRECT FOREIGN INVESTMENT IN CHINA

Equity joint venture (EJV) is a limited liability company organized in China by PRC and foreign investors in accordance with the Joint Venture Law and implementing regulations. The contract and articles of association are agreed upon by the parties. The company is jointly managed under the direction of a board of directors that is usually selected by the investors in rough proportion to their respective shares of the investment. Profits are distributed in proportion to such shares. Cooperative joint venture (CJV) is the name given by China to a collection of arrangements for long-run investment cooperation by Chinese and foreign parties in accordance with a contract between them that sets forth their responsibilities and rights, but that may not involve equity contributions by the partners. A wholly-owned venture (WOV) is a company organized in China solely by a foreign company that contributes the entire equity required, receives the entire profit, and independently manages the enterprise.

3.7 Prior to 1988, foreign investment in Hainan originated almost exclusively from Hong Kong, and Hong Kong investors continue to dominate DFI in Hainan to an ever greater degree than elsewhere in China, accounting in 1988/89 for over 80 percent of contracts and 70.6 percent of contractual value. However, Hainan's change of status in 1988 seems to have induced both a surge in the overall volume of DFI (to a degree not witnessed in the other established SEZs) and a marked increase in interest among potential investors from other countries, including Japan, Singapore, US and Thailand (as well as Taiwan Province). Industry--mainly processing and assembly--has comprised the

largest single sector for DFI involvement, accounting for 45 percent of total contract value over 1988/89. However, DFI in Hainan is more diversified by sector than that in the other SEZs: in Shenzhen SEZ, for example, the comparable share for industry was close to 75 percent. Real estate plus public utilities constituted the second most important sector by value of DFI in Hainan, accounting for 25.6 percent of the total, of which 14 percent was for hotels, reflecting the island's tourism potential. Other significant sectors included transport and communication (7.3 percent of the total), finance and insurance (6.5 percent) and agriculture, fisheries and forestry (5.1 percent). Average DFI contract size over 1988/89 was $0.84 million, which is reasonably comparable to averages for the other SEZs (Shenzhen: $1.56 million in 1988; Zhuhai: $0.99 million in 1988; and Shantou: $0.57 million in 1987). In the industrial sector, the average contract size in Hainan in 1988/89 was $0.75 million.

3.8 The first half of 1990 witnessed a decline in registration of new contracts compared to the same period of the previous year--probably largely reflecting the impact of the June 4 events on investor attitudes. Some 116 contracts were approved, with a value of $54.9 million, declines of respectively 55 percent and 74 percent over January-June 1989. This trend was observed throughout China.

3.9 The impact of foreign investment is starting to be seen in Hainan's overall output and export performance. At the end of 1989, 189 FIEs were in operation in Hainan, with a total production value of Y 440 million, or 8 percent of total provincial output. In 1989, 103 FIEs generated an aggregate of export earnings of $25.7 million, just over 7 percent of provincial exports (while this represents nearly a fivefold increase over 1988, it still falls short of the nationwide figure of 12.6 percent). Four FIEs had export earnings exceeding $2 million, one was in the $1-2 million range, and 12 in the $0.5-1 million range.

3.10 The generous treatment provided to export earnings in Hainan, until January 1991 (para. 3.4), had also made it attractive for mainland enterprises to invest in the province. As of end-1990, 4,706 such enterprises, with an aggregate registered capital of Y 6.48 billion had invested in Hainan: significantly, a large number of them (2,304) were engaged in trade, while 1,520 operated in construction and manufacturing, 880 in restaurants and catering and 2 in finance. Export (often re-export) earnings of these mainland enterprises totaled $105 million in 1990, an 80 percent increase over 1989.

C. Performance: Trade

3.11 Hainan's published data on trade pose serious problems of interpretation, due to the high volume of transit trade: i.e., the re-export of commodities generally produced elsewhere in China. Recorded exports, which stood at $81.1 million in 1985 and $115.5 million in 1987, soared to $295 million in 1988 and $360.8 million in 1989. The period from 1985 to 1989 also witnessed an apparently marked shift in the sectoral origin of exports, with agricultural products (including processed products) declining from 72.8 percent of the total to 33.5 percent, and textiles, industrial and mining products increasing from 27.2 percent to 66.5 percent.

3.12 It would be misleading, however, to view the above developments as an accurate reflection of changes in the level or structure of exports originating within Hainan itself. As noted earlier, the differences which presently exist between Hainan and the mainland in retention rights to foreign exchange earnings have made it attractive for mainland enterprises to establish trading operations within Hainan, and to route their exports to the outside world through the island. As long as the present divergences continue to exist, such transit trade, which offers marginal benefits to Hainan and imposes real resource costs to China as a whole, can be expected to continue and perhaps even grow. This represents, in a sense, an example of the kind of distortion that can be created by partial reform (similar to the familiar problems caused by the two-tier pricing system): the loophole will be best closed not by imposing restrictions upon Hainan but by further pursuit of reform on the mainland.

3.13 For the present, the re-export trade materially distorts the information available on both exports from and imports to Hainan. It is known, however, that in 1988 exports actually originating in the province were valued at $64 million (only 17.5 percent of the recorded exports, implying re-exports of $231 million). From 1988 to 1989, exports of domestic origin are said to have grown by a remarkable 78 percent in nominal terms, to $114 million or 34 percent of total exports, which--if accurate--would indicate re-exports of $247 million in the same year. It is understood that exports of domestic origin continue to be largely of primary products (in 1989, 54 percent from agriculture and related sectors, and 14 percent from minerals). As noted earlier (para. 3.9), FIEs contributed $25.7 million of the 1989 total (22.5 percent of domestic exports), and their continued development can be expected, over time, to lead to an increase in the contribution made to foreign exchange earnings by the industrial sectors, as well as to the "invisible" exports represented by services such as tourism.

3.14 Detailed analysis of import data for Hainan is similarly complicated by transit trade. However, a striking feature of the published statistics (Box 3.2) is that Hainan appears to have been running a substantial trade deficit over recent years: a point that is in marked contrast to the other SEZs. When the re-export trade is netted out of both sides of the balance, the disproportion between exports and imports becomes more striking. If, for example, the estimated re-exports of $247 million for 1989 were to be charged in full against imports, Hainan's trade balance exclusive of transit trade would have comprised exports of $114 million and imports conservatively valued at $293 million. The implied deficit of $179 million was largely covered by the inflow of foreign direct investment, estimated at $161 million in the same year. In view of Hainan's early stage of development as an SEZ, compared to the other zones, running a trade deficit need not per se constitute a source of concern, as long as it is the counterpart to an inflow of productive private sector investment, rather than public sector overseas borrowings.

D. Investor Perceptions: Constraints and Issues

3.15 Hainan's performance in attracting foreign investment and stimulating trade over recent years indicates that both quantitative and qualitative changes have occurred. The island's initial transformation to an SEZ was clearly responsible for an upsurge in interest from the broader international

Box 3.2: TRADE PERFORMANCE OF THE FIVE SEZs
($ million)

	Shenzhen		Zhuhai		Shantou		Xiamen		Hainan	
	Export	Import	Export	Import	Export	Import	Export	Import	Export	Import
1985	563	743	57	411	275	81	170	280	81	354
1986	726	1,121	71	123	407	109	164	115	38	56
1987	1,414	1,144	274	165	529	155	261	155	116	65
1988	1,849	1,593	421	215	771	291	576	298	283	490
1989	2,174	1,578	365	165	749	247	647	325	335	540

Source: Almanac of China's Foreign Economic Relations and Trade, 1985-1989/90.

investment community. Over the longer term, however, Hainan must come to grips with the reality that foreign investors will look at several different locations, within and outside China, before making a locational decision and that Hainan is but one of them. Having a set of regulations on paper that are slightly more advantageous than the other SEZs will not automatically assure a continuous inflow of foreign capital, especially if policy implementation should be perceived as less than fully reliable.

3.16 There seems to be room for Hainan itself to take a more proactive approach in seeking to attract foreign investors: with a more targeted approach towards sectors of potential interest; provision of more sophisticated information packages in English; greater use of investment and trade promotion missions; etc. But in the end, both Hainan and the center must recognize that the island will be judged on the perceptions that develop among actual and potential investors on its record as a host. A few successful examples of foreign investment projects would make a stronger impression on the investment community than any amount of verbal promotion, while a few large disputed cases that are allowed to drag on endlessly will be a liability.

3.17 The obstacles most commonly cited by the foreign business community are the difficulties and complexities surrounding negotiations with the government and potential joint-venture partners. The latter are seen as subject to internal directives and administrative guidance unknown to the foreign investor. They are also frequently affiliates of the central or local government, a fact that often subjects them to additional regulations. While these are problems generic to DFI in China, they are particularly disadvantageous for Hainan, which has yet to establish its reputation as a smoothly operating SEZ. It would make negotiations smoother and reduce unexpected surprises if HPG arranged to explain to the potential foreign investor in advance what approvals are required at each stage, who makes the decisions based on what criteria (with some specificity), what decisions are beyond the provincial government's control, and what rules, if any, govern the domestic joint venture partners. While there may be limits to how far HPG alone can simplify the decision-making process, clarification regarding the process would signif-

icantly improve foreign investors' perception of, and alleviate their anxieties about, doing business in Hainan.

3.18 Another major issue raised by investors is the prevalence of discretionary--as opposed to automatic--approval procedures and the lack of transparency of rules. There is seen to be a significant gap between what seems to be permissible automatically on paper and what is permitted in reality: in this respect, interference by central government line ministries is also common. A widely cited example is the proposed Yangpu Development Project.2/ It took more than four years after the submission of the proposal by the foreign investor to receive necessary central government approvals to proceed to the signing of a letter of intent between HPG and the foreign investor, but the first step is a long and expensive investment process. The major contentious issue was said to be the length of the lease, despite the clear endorsement in Central Government documents for long-term leases up to 70 years in Hainan and strong encouragement for foreign investment in infrastructure. It appears, as well that concerns over speculative profits caused some in Haikou and Beijing to press for detailed official approval of each venture in the lease area. This will likely be viewed as interference in investor action; if the concern is really real estate profits, capital gains taxation based on appropriate records would discourage such transaction. In another example quoted by foreign business people, handling of renminbi transactions by foreign financial institutions in Haikou has not yet been permitted by PBC headquarters, although relevant national and provincial regulations allow for local currency business by foreign banks.

3.19 Another issue which has raised concern both among foreign investors and within Hainan itself is the functioning of China's system of restrictive export quotas (entirely distinct from the system of export targets referred to above). Such quotas are applied (and administered by MOFERT) in the case of commodities where China is either required to restrict exports by international agreement (so-called "passive" quotas, e.g., for textiles or garments), or has concluded that it will be in its own economic interest to exercise perceived market power (e.g., sales of foodstuffs to Hong Kong and Macao). It is believed in Hainan that such quotas, at least as currently operated, unreasonably restrict the island from fully exploiting its comparative advantage in a number of export fields. It is also pointed out that FIEs engaged in the export of products covered by quotas are required, not only to receive prior MOFERT approval for their investments, but also to submit export plans for approval every six months, which is said to make their production planning difficult and unreliable. Quota requirements have presented obstacles for some large-scale foreign investors, e.g., in shrimp breeding and silk textiles, where investors have been denied permission to export their products.3/

2/ Formal approval was granted in March, 1992.

3/ Hainan has partially alleviated the impact of quotas by diversifying its export markets. In 1989, the share of the Hong Kong market had fallen to 72.9 percent, or 13 percentage points lower than in 1986. Further diversification would be desirable.

3.20 The rationale for the existence and commodity coverage of export quotas is an issue to be taken up at the national level, and should be kept under regular review. Beyond this, there are important efficiency and equity issues surrounding the way the quotas are currently allocated within China. At present, interprovincial allocations are made on an administrative basis, with much emphasis placed on prior historical levels. This gives little opportunity for new, potentially more efficient exporters to emerge through competition with established centers. There may well be justice in Hainan's belief that, as a newly established province, it suffers more than most from the inertia built into the present system. However, if the claim for Hainan's comparative advantage is to be put to the test of the market, it would be preferable, rather than using administrative measures to raise Hainan's quotas at the expense of other provinces, to reexamine the basis for present allocations. A system of periodic quota auctions would permit potential exporters throughout China--and in Hainan--to bid openly for the restricted export openings available (though, in the short term, and as long as differences in foreign exchange retention rights exist across provinces, some modification would be required to preserve a "level playing field").

3.21 More generally, investors report that regulations issued by the central and provincial governments relating to Hainan's preferential policies are, in practice, often overridden by those issued by the line ministries or other provincial decrees. Since Documents 24/26 are State Council documents outlining the Hainan strategy, in case of conflict they supersede documents passed by lower organs. Confusion arises when the central or provincial government issues regulations that override some of the original preferential policies due to temporary problems such as those addressed by the ongoing nationwide austerity policies. An example of the latter is the "Temporary Regulations on the Import and Export Plans of Hainan Province (Draft)" which were issued apparently to stem the trade deficit and in particular to reduce the import of consumer goods. While the trade deficit and import structure are genuine sources of concern to the provincial government, the authorities should recognize that instructions contradicting the broad thrust of Hainan's strategy will serve to undermine the confidence of investors, who are looking for a stable environment and a set of well-defined rules when deciding where to invest.

3.22 In terms of organizational structure, despite Hainan's slogan for a small government and simple procedures, and the establishment of the Investment Promotion Committee (an affiliate of the Bureau of Economic Cooperation) as the principal contact point for foreign investors, any potential export-oriented foreign investment project is in effect subject to the approval of both the Bureau of Economic Cooperation, which oversees foreign investment, and the Bureau of Trade, which oversees exports (unlike the central government structure, where MOFERT oversees both). Approval procedures for such projects could be considerably simplified by expanding the authority of the Investment Promotion Committee so that it can act as a substantive one-stop investment agency, as is now being discussed..

3.23 Hainan's development zones (industrial estates) managed by municipalities or joint ventures appear to be satisfactorily serving the physical infrastructure needs of a large number of investors. There are seven such zones either already operating or under construction. The four in Haikou are

differentiated by functions, one each specializing in: banking and trade; production and housing; industry; and processing for foreign trade. The other three development zones are in Wenchang, Chengmai and Lingao Counties, and are expected to become focal points for industrial development in the respective localities (Box 3.3).

3.24 There seem to be no major infrastructure bottlenecks at the current level of investment. But if investment in productive areas is to expand there are issues that would need to be addressed, such as transportation, cargo handling, and power supply. Human capital is adequate for straightforward processing and assembly operations, the mainstream manufacturing DFI to date, where the most important attributes of the labor force are discipline, good eyesight and dexterity. In the longer run, however, availability of managerial, professional and skilled personnel will need to be considered if the SEZ is to diversify into more technologically advanced areas.

E. Authority and Policy

3.25 The provincial authorities have periodically made the case for broader powers to enhance their ability to attract foreign investment and promote trade. When discussions over Hainan's proposed change in status were underway in 1987, for example, consideration was apparently given to the establishment of a Special Customs Zone (SCZ) as well as of a separate, and fully convertible, currency for the island. Hainan's representatives reportedly chose not to press the issues, at the time, out of concern over the possible impact on the island's quotas of raw materials and grain from the mainland.

3.26 The Special Customs Zone has been envisaged as a zone with two "lines" for custom purposes, one "line" open to the international market as a free trading zone, and a second "line" separating Hainan from the mainland with a strict system for inspection and control of trade between the mainland and Hainan. Trade between Hainan and the mainland would be treated in the same way as external trade: inter alia, import tariffs would apply to goods shipped from Hainan to the mainland. The SEZ's promoters apparently hoped that it would be exempted not only from central government import restrictions, but also from export quotas other than the "passive" quotas discussed above (though this feature does not appear inherent to the zone's operation). As noted above, the argument has also been advanced for a separate Hainan currency, in which trade with both the outside world and the mainland would be settled. By implication, Hainan would gain the authority to conduct its own monetary policy, divorced from central decisions on credit allocations.

3.27 It is not clear that proposals of this kind go to the heart of the issues involved in improving Hainan's investment climate. If the powers already granted to the province on duty and tax exemptions, retention rights, and operation of foreign exchange markets are in fact fully available and fully availed of, then the advantages of duty-free status and convertibility can in effect be achieved under existing arrangements. It may be argued that the emphasis still placed by PBC on directed credit is not in the best interests of a market economy, and Chapter 5 argues for greater application of market principles to the allocation of credit within Hainan. However, even if

Box 3.3: DEVELOPMENT ZONES IN THE HAINAN SEZ

At the end of 1989, there were seven development zones partly operating or under construction, and another for which the plan had been approved. They are: Finance and Trade Development Zone along Binhai Avenue, Haikou; East Haidian Island, Haikou; Hong Kong-Macau International Industrial Zone, Haikou; Jinpan Industrial Zone, Haikou; Laocheng Industrial Zone, Chengmai County; Jinpai Economic Development Zone, Lingao County; Development Zone in Danxian County; and Qinglan Development Zone, Wenchang County (plan approved). The four in Haikou are differentiated along functional lines (finance and trade, production and housing, industry, and export processing) in order to facilitate unified planning and coordinated development.

In addition, there is Yangpu, which in March 1992 received central government approval. The Yangpu Development Zone was set up on the basis of the idea of "contracted development of large tracts of adjoining land with comprehensive compensation." It is hoped that the Development Zone would attract on a large scale investments from foreign consortia.1/

There are three different structures for managing the zones: (i) a management committee is sent in by the government as in the case of Qinglan and Laocheng; (ii) the zone is managed and developed by companies as in the case of development zones in Haikou; and (iii) a development institution is jointly set up by the government and companies, as in Jinpan Economic Development Zone. The status of the development zones, as of end-1989, are described below.

Finance and Trade Development Zone along Binhai Avenue, Haikou. The zone covers an area of 2.2 km² along Binhai Avenue in Haikou City. In infrastructure, Y 111 million has already been invested. It is an integrated development zone with finance and trade as its backbone, supplemented by public amusement and vacationing functions. The zone will become Haikou's center for finance, trade and foreign exchange activities. Construction of nine projects is under way. The total planned investment of these projects was Y 274 million and involved total construction area of 175,600 m², of which over 40,000 m² had already been completed. Six projects with planned investment of Y 224 million and construction area of 124,500 m² have been approved. Designing is approved for nine more projects with planned investment of Y 263 million.

East Haidian Island, Haikou. Thus far, Y 200 million has been invested for infrastructure construction. It is designed to become a satellite town of Haikou city. Facilities planned for this zone include: luxury apartments, housing buildings, villas, hotels, modern business centers, office buildings, schools, hospitals, recreational facilities and pollution-free hi-tech industries. Representative offices of other provinces and cities and international consortia, foreign consulates will be located here. An office and shopping complex with a planned construction area of 100,000 m² is under construction with 60,000 m² completed.

Hong Kong-Macau International Industrial Zone, Haikou. This is an outward-oriented industrial development zone with an area of 2 km², managed and built by Hainan International Investment Company. It is expected to become an "export processing zone" made up of 200-300 mainstay export enterprises with total employment of about 95,000. Light industry, textile industry, garment, shoe-making, electronic products, food and plastic industry are expected to constitute the backbone of the industrial structure of the zone. By end-1989, Y 79 million had been invested in land requisition and infrastructure construction. Five production projects with total investments of Y 95.75 million are completed and operational: Nanyin Shoe Factory of Hainan; Hainan International Shoe Factory; Hainan International Emulsion Product Company; Nanfang Color Pressed Product Company of Hainan; and International Huayun Automobile Repair and Assembly Center. Eleven more projects are under construction with planned investment of Y 79 million, of which Y 65.27 million is already invested.

Jinpan Industrial Zone, Haikou. This zone is a 16.53 km² area located in the southwest suburb of Haikou city. Industrial production is its mainstay with science, industry and trade given equal importance It will have a comprehensive facility system for production, living and services. This zone is entrusted with the duty of introducing technology and capital for Haikou's industry, readjusting industrial structure, and serving as a conduit through which to join the international circulation. An investment of Y 105 million was made for infrastructure construction. Nineteen projects started construction with a planned investment of Y 100 million, of which Y 68 million is already utilized. There are three projects currently operating: Hainan Nanbao Joint Magnetic Material Factory; Electronic Component Factory; and Haizhou Industrial Company's casting calcium carbide production line. Sixteen projects are under construction.

Laocheng Industrial Zone, Chengmai County. The zone is located in the newly opened industrial city of the county. Its planned mainstay industries are light and textile industry, food, petrochemical, machinery, electronics, and nonferrous processing. At the end of 1989, there were 72 projects under way with five in operation: Hainan Ramie Textile Mill; Puhua Export Product Processing Factory of Chengmai; Acetylene Steel Cylinder Factory; Flax Degumming Factory; and Chengfu Filling Station of Chengmai. Fourteen more projects with a combine total investment of Y 54 million are under construction.

Qinglan Development Zone, Wenchang County. The overall plan was approved by the Hainan Provincial Government in 1989.

Jinpai Economic Development Zone, Lingao County. This zone consists of 10 km² comprising two areas: the industrial area of Hongpai harbor; and a seaside tourist resort of Lingao Cape. The zone will rely on its harbor for developing its mainstay industry supplemented by other such as shipping, storage, commerce and trade, breeding, cultivation and tourism. It will be managed by the Jinpai Development and Construction General Corporation jointly set up by Lingao County Government and Jindao (Group) Company of Hainan Province.

institutional development within Hainan had reached the stage at which the province could confidently be expected to assume responsibility for the overall conduct of an independent monetary policy, the case for an independent currency cannot be established.

3.28 More relevant to Hainan's foreseeable future, as is implied by the discussion in Section D above, will be strengthened efforts by both provincial and national authorities to capitalize on the existing incentive structure and to ensure that potential and actual foreign investors face stable economic conditions, and project approval and decision-making systems that are straightforward, predictable, and prompt. In parallel, Hainan must continue to promote the efficient development and provision of necessary infrastructure and support services, to ensure these can match those offered by its international competitors.

IV. INFRASTRUCTURE DEVELOPMENT

4.1 The JICA report, completed in early 1988, assessed the island's development and infrastructure needs in considerable depth but could not, owing to its timing, examine the reform potential Hainan's provincial and SEZ status may allow. By contrast, the 1989 CASS studies focused more on the reforms than the infrastructure thought necessary to realize the potential of a market-oriented economy. This chapter examines the priorities for investment in the infrastructure required to support the province's development.

4.2 Infrastructure Status and Priorities. The JICA report identified Hainan's three main natural advantages as: its tropical climate, its abundant agricultural and mineral resources, and its proximity to the growing markets of East and Southeast Asia. The report also cited three disadvantages: its location on the periphery of China (albeit near the rapidly growing markets of southern Guangdong and Hong Kong), which increases transport and communications costs; its limited energy potential; and, until the early 1980s, its traditional role as a supplier of unprocessed agricultural and mineral raw materials to the mainland. On the basis of these features, the JICA study proposed that Hainan: increase the utilization of its agricultural resources, e.g., by expanding cultivated area, improving yields, afforestation and developing water resources; expand mineral processing; develop tourism at Sanya; upgrade its industry by introducing foreign capital and technology, and by ensuring reliable electricity supply; and improve transport, urban and other services necessary for export-oriented industrial development. China's four other SEZs enjoyed substantial central government support for transport, energy and urban infrastructure when they began their development in 1979. While the legal and regulatory context is important, trade and investment in Hainan will also be affected by the available infrastructure. In this regard, Hainan has succeeded in putting in place what it needs to get started.

4.3 Hainan's electric power generating capacity has grown rapidly since 1988. In 1988, two sets of 25 MW gas turbines were installed, and 50 MW thermal units went into production; thus, installed capacity in Hainan reached 295.6 MW, more than twice that of the previous year. In 1989, two 125 MW thermal generators were commissioned near Haikou, and in early 1990, the Macun thermal power station went into service, bringing the total installed capacity in the island to 776 MW. Industrial users in Hainan still complain, however, of outages and voltage fluctuations. This underlines the need for an extended and more reliable distribution network, as well as further improvement in the management of the power company. The province has a full network of post offices and telecommunications, with automatic dial telephone networks capable of mainland and international communications in Haikou and Sanya. Because of the seasonality of Hainan's rainfall and the short, quickly flowing rivers, water supply and water conservancy projects have received much attention. Investments include the Daguangba multipurpose irrigation and hydroelectric power project, which will further expand power generation capacity and harness the Changhua River for irrigation and flood control.

4.4 Hainan's basic road network was put in place by 1965. Since becoming a province, Hainan has constructed one 60 km high quality road to serve

Box 4.1: BASIC STRATEGY FOR SPATIAL/INFRASTRUCTURE DEVELOPMENT IN HAINAN

Short-/Medium-Term Strategy	Current Status
Concentrate on Haikou and Sanya	Data on distribution of public sector capital expenditure shows that in 1989 65 percent was in these two cities, increasing earlier high proportion.
Construct Haikou, Sanya and Yangpu Port	Under construction
Construct Sanya and New Haikou Airports	Sanya now under construction
Construct Haikou export-processing area	First factories already operating
Construct Yangpu industrial area	No decision yet taken
Development of trunk highways	Eastern Haikou-Sanya road under construction
Development of Changhua and Nandu rivers	Daguangba (Changhua) hydro/irrigation project under construction
Develop electric power	1991 installed capacity 776 MW, but distribution and transmission still inadequate
Medium-/Long-Term Strategy	
Develop Nada, Basuo and Qionghai, which with Sanya and Haikou would be centers for five economic regions	-
Construct Basuo and Wuchang ports	Development depends on industrial investment to be served
Construct Yangpu-Nada and Shiuwei-Basuo industrial corridors	"
Construct Sanya export-processing area	Development depends on resolving environmental issues, compatibility with tourist development to that date
Construct rural highway network	-
Develop Wanquan river water resources	Develop electric power

Source: JICA Study (English Translation), p. 300.

the Yangpu port and, with partial financing from Japan's Overseas Economic Cooperation Fund, has started construction of the 269 km eastern highway between Haikou and Sanya (via the island's eastern/southern coast). There are 14,348 km of highways, giving the province a road density of 38 km/100 km^2, four times the national average. Three north-south roads and four east-west roads form a network. In 1987, highways accounted for about 72 percent of total freight transported of 1,651 million ton-km and over 94 percent of passenger transport volume of 3,919 million passenger-km. There is one 214 km railway, linking the iron ore mine at Shilu and the salt flats at Yinggu to ports at Basuo (iron) and Sanya. Transport volume in 1989 included 3.61 mil-

lion mt of iron ore, 244,800 tons of industrial salt, 173,800 tons of coal and about 125,000 tons of other industrial materials and food. There are two international airports, at Haikou (2,560 m runway) and Sanya (3,400 m runway under construction). Hainan has 17 harbors along its 1,528 km of coastline. Xiuying Port at Haikou has 15 berths, including two 5,000-ton general cargo berths and about 53,600 m2 of storage area, and an annual capacity of 1.7 mtpy. Two 10,000-ton cargo berths are under construction: this will expand port capacity by 800,000 tpy. Basuo port is the only port able to handle 10,000-ton vessels, and the only port in China specialized in shipping iron ore. When construction of two moles by the Ministry of Communications is completed in late 1991, its capacity will be expanded to 4.96 mtpy. Sanya port can handle 650,000 tpy. Yangpu port, on the east side of Yangpu Bay in northwest Hainan, is a natural deepwater port with considerable potential (para. 3.18).

4.5 Despite the considerable progress noted above, Hainan still faces infrastructure constraints and, in the coming decade, will need to:

- ensure reliable electric power by increasing transmission and distribution following the recent expansion of generating capacity, and through improvements in the technical and business management of the power company;

- expand urban water supply and sewage/wastewater disposal in Haikou to support the development of industry and commerce, and the resulting increase in the urban population; and

- gradually raise the volume and quality of telecommunications, urban transport and municipal services; and undertake water control and conservation projects to provide irrigation and improve soil conservation.

4.6 Setting Priorities. Like other provinces, Hainan prepares a five-year development plan, setting out targets for economic growth and output, and identifying priority investments in infrastructure and production. The paragraphs below discuss the various infrastructure investment priorities that have been proposed over the last five years, first in the JICA study and more recently by the authorities after Hainan became a province, suggesting a market-oriented approach to public investment and its financing.

4.7 Infrastructure development in Hainan will need to support both rural and urban development according to market-oriented principles. In rural areas, the state farms are responsible for virtually all physical development in the land under their control. Accordingly, the province could take advantage of this established organizational framework and the enterprises' capability and interest in the infrastructure needed to support further agricultural development. Consistent with enterprise reform in the rubber sector (paras. 2.15), processing and storage facilities necessary for production of rubber and other crops could also be taken up by the state farms on a commercial basis. To the extent that they provide processing and marketing services for other crops produced by their staff on their own account and by nearby smallholders, and traded mainly on the market, they should do so, but not enjoy a monopoly position. Linking rural production to markets in Hainan,

other parts of China and abroad suggests a more selective view of transport infrastructure than is evident from current plan priorities. Construction of the "around the island railway" would not offer as flexible or economic transport services as concentration on the three north-south highway links, supplemented by rural and feeder roads. Road transport also opens greater potential for private sector service provision, and for intermodal links that would permit containerized handling of raw materials and finished products through modern ports at Yangpu and Haikou. Consistent with its poverty policy (para. 1.11), infrastructure (transport, water supply, and energy) in minority and mountainous areas also need to be taken into account, to create an enabling environment for production activities in these areas and market access for them.

4.8 In urban areas, transportation, electricity, water supply and sewerage, telecommunications and serviced land will be needed for industrial development, with particular emphasis on sea and air transport links to the mainland and overseas markets, reliable energy supplies, and environmental quality. In reviewing its priority urban projects, the provincial government should distinguish between investments that could be built and operated according to market principles, and those more appropriately controlled by the government itself and financed through general revenues. The former includes electric power, water supply and sewerage, and telecommunications, while the latter includes roads and urban streets. Urban transport and municipal services offer considerable potential for provision by the private sector. The priorities sketched out in the JICA report (Box 2.1) call for concentration on Haikou and Sanya in the first phase, as well as the construction of the Yangpu export zone and port. This focus on transport, energy, and water resource investments would appropriately support development of resource processing industries as the base for later expanding nonagricultural development to smaller cities in the interior of the island.

4.9 Hainan's long-term prosperity will depend on human resource development, in particular expanding literacy so that a skilled workforce can meet the needs of market employment. Attention to the training of girls and minorities would help reduce poverty in the province. Hainan's Education Bureau reports many of the same problems faced in other poor areas of China. For example, only 15 percent of primary schools and 20 percent of middle schools have adequate teaching equipment. While the desirability of government-financed expansion of specialized vocational and technical training has been questioned in China and elsewhere, the province plans to construct twenty-two 800-1,000 pupil vocational secondary schools during the Eighth Five-Year Plan period (1991-96). However, the cost-effectiveness of this strategy has yet to be demonstrated: international experience shows that general secondary education, rather than narrow, and frequently obsolete technical training is often more appropriate. An option worth exploring is further encouragement of proprietary technical schools.1/ Studies in other countries show that for

---

1/ Privately-run schools, 56 of which have already been established (mainly in Haikou), teach foreign languages, tourist trade, cooking, building trades, art and typing, and in the past two years have trained about 9,400 school leavers. There are about 35,000 students now studying part time in these schools.

practical skills, these "for profit" schools, which typically cost Y 200-300 tuition per year, are a more flexible, and far cheaper, form of training than government technical secondary schools. Such a strategy would also avoid transferring scarce resources away from basic and general secondary education, (which have the highest social and economic returns) and minority education, where Hainan acknowledges it still needs to make improvements.

4.10 Overhauling Provincial Investment. In addition to capital construction, which accounts for about 15 percent of expenditures, Hainan has a more general program of investment, amounting to some Y 2.2 billion, supported, inter alia, by bank loans and domestic borrowing (25 percent), foreign capital (14 percent), and "self-mobilized funds" of ministries, departments, enterprises and administrative units (43 percent). Only 10.6 percent of investment was funded from the national budget, compared to 76 percent in 1978, following the proclaimed national policy of shifting from direct appropriations to other financing sources. As Chapter 5 will discuss, Hainan's current dependence on central appropriations to finance the public sector-funded infrastructure investment is probably unsustainable in the long term, and new financing sources will be needed. The current arrangements, which provide for Y 1 billion in central government capital development funding over five years, expire in 1995.

4.11 The provincial government should review the list of investments proposed for implementation during the Eighth Plan to identify a core Public Investment Program (PIP). The criteria for this screening should include: the nature of the "good" and therefore the justification for its realization by the provincial government rather than by private local or foreign investors at their own risk and with their own funds; the availability of an up-to-date feasibility study, with reliable estimates of costs and benefits; the availability of completed detailed engineering to a suitable standard; the impact on the local materials and civil works industries of proceeding in the next five years; and, where applicable, an environmental impact assessment. In this first cut, infrastructure projects supporting private investment already firmly committed should receive priority. This implies a continued geographic focus on Haikou, Sanya and Yangpu. The planners' assumption should be that government investments will be ranked and limited, with public goods (schools, hospitals, roads) receiving high priority. Utilities (where the history of and scope for public sector involvement is reasonably strong) should shift to the model of the publicly owned but financially self-sustaining utility, making investment decisions on commercial grounds. Keeping in mind public resource constraints, and the strong history of efficient private sector provision, housing, where private investment and even privatization of the existing stock may be entrusted to the private sector. In this case, arrangements would need to be made for reform of the existing state-owned housing stock that permit housing markets to develop. And, after a halt to the creation of new SOEs and privatization of the current ones, investment in buildings and capital equipment for enterprises would no longer figure in Hainan's PIP.

4.12 To exploit its potential, Hainan needs to create a policy environment that will promote local and foreign investment and ensure its productive and efficient use. In doing so, the role of the central government and the support it offers require special examination.

4.13 In addition to ensuring macroeconomic stability through appropriate fiscal and monetary policy, and influencing investment through export quotas and exchange rate policy, the central government exercises two important development functions in Hainan. First, as the owner of the rubber resources and the allocator through the Plan of output from the iron ore mine, it effectively controls the state farms and the iron mine and its dedicated railway. The central government, and companies owned by it, buy the entire output of these two industries, which together account for one-third of Hainan's GVIAO. This role is exercised by the State Planning Commission and the Ministry of Metallurgical Industries for Hainan Iron Ore Company, and by the Ministry of Agriculture for the rubber plantations. In the case of offshore natural gas exploitation, the central government and its private partners play a similar role (para. 1.8). Second, the State Planning Commission approves public investments in infrastructure and, when foreign concessional financing is intended, the source and terms of such borrowing. The counterpart funding of some public investments is directed through central government line ministries and the State Investment Corporations, to which Hainan province must address its financing requests.

4.14 These two roles have slightly different implications for Hainan, with both positive and negative effects. As productive units reporting to the central government, the state rubber farms and Hainan Iron Ore Company do not necessarily take account of provincial development objectives or land use concerns in making investment and production decisions. Unlike other, mainly private or foreign investments Hainan is seeking, their potential for exporting their output is constrained by state decisions on quantities to be allocated at Plan prices to mainland enterprises.2/ Their production is fully "spoken for" as part of national output targets set through the central planning mechanisms, and they are entitled to fixed quantities of inputs at normally below market, Plan prices. Investment and production decisions by SPC may well take account of external market conditions and international competitiveness and efficiency considerations--increasingly so, one may anticipate, as China's overall reforms proceed. But under the current system, Hainan's two main industries are effectively buffered from international price signals and competitive pressures. Their importance in national production of steel and rubber products may make the central government reluctant to have them included in Hainan's overall reform effort. But since both sectors account for substantial employment, Hainan has a strong interest in assessing their prospects and participating in plans for their development. HPG and the iron ore company are seeking SPC approval for a Y 900 million, 300,000 mtpy steel mill to use low-quality ore powder. As Hainan lacks good quality coal, and there may be better, higher-value uses for eventual natural gas output or expanded electricity production, a rigorous evaluation would be required of any such plans. Hainan's rubber farms have recently developed a strategic plan for replanting and expanded production in the 1990s. As was developed in Chapter 2, if the rubber farms' competitiveness and long-term viability are in doubt, their development prospects need to be assessed by Hainan and the central government together. For natural gas, which has yet to be developed, the

---

2/ For comparison, Hainan's fob price (Y 40.7/mt) seems low. It is only about 25 percent of the estimated c.i.f. cost for Australian iron ore delivered in Japan, the f.o.b. price of which, ex-Australia, is estimated at 60-65 percent of the landed cost.

high development costs, foreign investor involvement, and substantial export potential make it likely that market considerations will drive any future investment decisions. This is, therefore, a sector where public sector involvement and investment need not be assumed, the more so given Hainan's favorable environment, as an SEZ, for investment.

4.15 Investment in Hainan in these three strategic sectors will be determined largely by decisions of the central government and its line ministries. Changes touch matters of central/local relations, including the ownership and control over natural resources and the taxation of production in a particular location. While these generic issues are not peculiar to Hainan, or to these natural resources, Hainan may wish to seek a share in the iron ore and rubber enterprises, particularly in light of the land use impact both sectors have on the physical environment. If ownership of these activities remains with the central government, Hainan will wish to reach understandings over the environmental standards to be observed and how they are to be monitored and enforced. It may seek some compensation for the resources exploited in its territory, through resource taxes or royalties, which could form part of its development budget. It may also wish to agree with the enterprises on the sharing of responsibility for social services for the companies' workers and their dependents.

4.16 While SPC approval of investments over Y 200 million 3/ is intended to see that national priorities are observed, the appropriateness of this control in Hainan's case is open to question. This is true both for projects of a "public good" nature (infrastructure, including health and education) and those with a direct production goal. Hainan's island location means that its transport and energy infrastructure is not part of a connected national network or grid. Its water resources similarly do not have an impact on other provinces, a physical and environmental argument for some supraprovincial control or coordination of planning and implementation of water conservancy projects. Its productive investment is meant to take place according to market principles, and private, and particularly foreign, investment are to be strongly encouraged. For these reasons, it is unclear why the central government, either SPC or the line ministries, would continue to play such a major role in the investment approval process. Investment financing is a separate issue, and relevant agencies such as the State Administration for Exchange Control should review foreign borrowing by Hainan, as they oversee it for other provinces. It appears, moreover, that the line ministries' financing capacity has been severely limited since 1988, so that Hainan's requests for funds for a particularly project, however desired by agencies in Beijing, have not succeeded in attracting much direct central government financial support. More generally, central planning and the bodies responsible for it in China operate on the principles of the Plan, and Hainan's goals and requirements are linked to the imperatives of the market. Thus, the planning process and how public investment is financed in Hainan need to be evaluated, in light of the role intended for nonstate investment, the reform context China has set for the province, and the resources Hainan can mobilize to these ends.

3/ Y 30 million elsewhere in China.

V. ISSUES IN HAINAN'S FISCAL AND FINANCIAL POLICIES

A. Fiscal Resources and Policies

5.1 Hainan is one of 13 provinces, which, under the Chinese system of revenue-sharing, receive transfers from the center.1/ A small and poor province, Hainan has a limited tax base with revenues concentrated in Haikou, the capital. A so-called "deficit province," Hainan is entitled to retain all revenues collected within the province, and receives an annually negotiated budgetary supplement. Overall, Hainan's public finances rely heavily on central government support, which is currently assured (though in decreasing real amounts) until 1995.

5.2 Budgetary Trends. Table 5.1 shows trends in revenue and expenditure during 1978-89. While both increased in nominal terms over the period, collections barely kept pace with the growth of provincial income. But the ratio

Table 5.1: HAINAN PROVINCIAL GOVERNMENT FINANCE REVENUE AND EXPENDITURE
(Y Million)

	1978	1984	1985	1986	1987	1988	1989	1990
REVENUES	136.35	305.48	316.13	258.94	295.88	482.36	624.81	738.94
Tax revenue	132.30	300.12	408.17	318.72	350.68	510.59	614.79	620.23
Ind'l & commercial taxes	n.a.	260.83	328.70	229.56	266.88	365.36	424.86	
Salt tax	n.a.	18.31	19.43	22.81	13.07	19.52	19.38	
Agriculture tax	n.a.	20.98	23.33	34.96	39.91	12.23	17.78	
Profit submission	n.a.	-3.57	2.01	0.91	1.37	18.53	34.34	82.13
Other revenue	n.a.	8.93	12.99	16.30	10.84	29.90	70.74	
EXPENDITURES	166.95	452.83	589.94	663.05	672.21	924.75	1,380.90	1,742.47
Capital construction	n.a.	40.57	136.06	77.61	46.89	125.49	246.51	
Agriculture support	n.a.	46.21	52.60	55.46	56.74	79.96	142.20	169.08
Education & health	n.a.	142.16	168.65	216.66	223.28	285.02	361.08	446.27
Education	(n.a.)	(n.a.)	(108.86)	(147.06)	(147.21)	(189.23)	(236.08)	
Administration & management	n.a.	104.69	88.92	105.35	118.91	109.73	143.74	
Special expenditures	n.a.	13.89	35.77	87.16	80.30	123.89	245.39	
Price subsidies	(n.a.)	(n.a.)	(n.a.)	(49.49)	(51.99)	(102.63)	(161.37)	
Grain subs. to price diff.	(n.a.)	(n.a.)	(n.a.)	(27.65)	(31.47)	(25.25)	(43.58)	
Enterprise renovation fund	(n.a.)	(n.a.)	(16.21)	(17.24)	(23.46)	(19.94)	(35.72)	
SOEs subsidies	n.a.	n.a.	n.a.	76.99	67.01	76.66	95.06	
Other expenditures	n.a.	105.31	107.94	120.81	146.09	200.86	241.98	
BALANCE (REVENUE-EXPENDITURE)	-30.6	-147.35	-273.81	-404.11	-376.33	-442.39	-756.09	-1,003.53
Memo Items:								
China								
Revenues/National income	37.2	26.0	26.2	27.8	24.3	21.2	21.4	
Expenditures/National income	36.9	27.4	26.3	29.7.	26.3.	23.1	23.2	
Hainan								
Revenue as % of national income (%)	10.3	9.8	8.9	6.6	6.5	7.8	8.7	9.5
Expenditures as % of national income (%)	12.6	n.a.	16.5	16.8	14.8	14.9	19.1	22.3

Note: All data are before revenue transfers to or from the central government. Figures have been adjusted for Chinese definitions of revenues and expenditures, which include SOE subsidies as a "negative revenue." Here, SOE subsidies are included as expenditures but not re-added to revenues.

Sources: Hainan Statistical Yearbook 1990 (HSY90), pp. 622-623 for 1980-89; p.66 for 1978/79.
Other items, see other tables and Hainan Statistical Yearbook 1989 (HSY89). Data on 1990 are preliminary.

1/ Other provinces include Inner Mongolia, Jilin, Jiangxi, Guangxi, Tibet, Guizhou, Yunnan, Shaanxi, Gansu, Qinghai, Ningxia, and Xinjiang. Any discussion of intergovernmental fiscal issues in China does not take into account the transfers implicit in the indirect taxation of grain, or subsidized prices of Plan commodities such as iron ore, steel, cement, or timber provided to users as part of their Plan allocation.

of revenue to provincial income has been much lower than the national average. Expenditures have grown significantly in real terms, outpacing provincial income growth. While Hainan's economy is based on agriculture, many counties are poor, especially those with large minority populations (Tongshi, Qiongzhong, Baoting and Ledong). Moreover, the major agricultural activity, state farm rubber production, does not yield any tax revenues for the province: the transfer price, which exceeds the international price, is fully absorbed by the rubber farms' production costs and other expenditures. As a result, Hainan's dependence on the center has grown.

5.3 Revenue Sources. As in other provinces, industrial and commercial taxes (ICTs) are the most important revenue source, accounting for 84 percent of total collections in 1989. Of the three ICTs, the business tax contributes most--43 percent in 1989--but VAT, a relatively new addition to China's tax system (and levied on industrial products only), is now eclipsing product tax (which decreased from 36 percent in 1987 to 9.4 percent in 1989) as the second most important indirect tax. Indirect taxes are now increasingly collected from private, collective and joint-venture enterprises, reflecting Hainan's changing economic base. Income tax and profit remittance from SOEs which are not losing money accounted for about 10 percent of total collections in 1989. Agriculture tax and cultivated land occupancy tax in 1989 provided only 9 percent of provincial collections. The energy and transportation tax (ETT) and extrabudgetary tax (ET), levied on extrabudgetary revenues, are retained 100 percent and 50 percent, respectively. Haikou City accounted for 36.6 percent of total collections in Hainan in 1989, followed by the provincial government at 21.7 percent. The remaining 41.7 percent was unevenly generated by the other 18 local governments.

5.4 Tax Incentives. Local governments in China have substantial discretion in implementing tax policy and, as an SEZ, Hainan has additional latitude to introduce special policies designed to attract domestic and foreign investment. Hainan's most important preferential tax policy is its 15 percent income tax rate 2/ for both foreign and domestic enterprises established after July 1, 1988. The different treatment of old and new enterprises leads to substantial distortions, however. Moreover, because the tax base is different for domestic and foreign enterprises, despite the uniform 15 percent nominal rate, effective rates and burdens are very different. The system has not, therefore, created the "level playing field" that was intended. This unequal treatment is compounded by additional tax incentives for "favored" activities. For example, new enterprises engaging in capital construction or infrastructure--such as harbors, airports, power stations--enjoy a five-year income tax exemption beginning in the first profit-making year. Finally, the absence of clear accounting rules and efficient tax administration create loopholes for new enterprises by enabling them to manipulate their accounts, avoid paying income tax, and delay the date after which they pay taxes at a reduced rate.

2/ A similar situation obtains since 1985 in Shenzhen, which has a unified 15 percent rate for SOEs, collectively-owned enterprises, individual enterprises, and Chinese joint ventures.

5.5 Tax Administration. While Hainan has taken several measures to improve tax administration, there is still much room for improvement. As in other parts of China, tax officials enjoy and exercise a substantial degree of discretion, and individual taxpayers often negotiate their final payments. Vigorous collection and management measures are still lacking, resulting in widespread tax evasion. The complicated tax structure, with many different rates and brackets varying by industry, further burdens a weak administration. Among Hainan's reforms is the assignment of different tax officials to perform tax collection, management and inspection functions separately.3/ Whether this will reap the benefits desired remains to be seen.

5.6 Expenditures. Over the 1979-90 period, expenditures have grown more rapidly than GNP, particularly after Hainan became a province. In 1989, the provincial government directly accounted for 42.7 percent of public expenditure, Haikou accounted for 9.2 percent, with the remaining 48.7 percent undertaken by other localities. This trend is unusual, in that for China overall, the expenditure/GNP ratio fell; a declining ratio also characterized most poor provinces with similar per capita revenues and expenditures.

5.7 A major reason for the rapid expansion of expenditures was the near-doubling of capital construction in 1988/89, which contribute to the improvement in Hainan's infrastructure. There was, however, also a 31 percent increase in administration and management expenditures, largely due to an increase of government personnel, and the addition of several bureaus to the provincial government two years after Hainan became a province (para. 3.21). While the essence of "small government" should be reduced intervention in the economy, expansion of the civil service rolls implies that the policy was not strictly implemented. "Agriculture support" nearly doubled, with a 60 percent increase in price subsidies, also accounting for the rapid increase in expenditures. While generally expenditures at the local level are limited to what is collected, Hainan seeks to increase the expenditure capacity of poorer counties by using the "collections surplus" of, say, Haikou to supplement the more limited local resource base elsewhere.

5.8 Subsidies. An important factor contributing to Hainan's weak fiscal position is the large expenditure on subsidies, especially to loss-making SOEs. State-owned grain companies, which are required to sell grain at below-market prices, receive "planned subsidies" of some Y 40 million and, in 1989, about 35 percent of the Y 260 million total subsidies were for grain. Another Y 95 million in subsidies goes to SOEs and there is an additional Y 164 million in consumer price subsidies. Total subsidies are equivalent to about 20 percent of total expenditures. In aggregate terms, net transfers to SOEs were thus a burden on the provincial budget.

5.9 Public Investment. The sharp increase in capital construction was one of the main reasons for the rapid expansion of total public sector expen-

---

3/ For a detailed analysis of China's reform experiments in tax administration, see Charles Vehorn, Yin-Kann Wen, and C. Eugene Steuerle, China: Evolving Reforms in Tax Administration, International Monetary Fund, October 25, 1990. See also "Revenue Mobilization and Tax Policy," op. cit.

diture since Hainan became a province. Total capital construction nearly tripled from 1987 to 1988, and nearly doubled again to Y 246.5 million in 1989. Its share of total expenditure increased from 7.0 percent in 1987 to 13.6 percent in 1988, and 17.9 percent in 1989. During 1988-90, the central government gave Hainan a total of Y 800 million in Development Construction Funds: Y 127 million in 1988, Y 265 million in 1989, and Y 417 million in 1990. Notwithstanding this support, identifiable local and foreign borrowings account for about 34 percent of the financing. Enterprise and institutions' own funds, about one-third of total capital outlays, may also include borrowing.

5.10 Available data on Hainan's public sector capital expenditure suggest a high and growing level that may lead to unacceptable demand pressures on its economy as well as a potentially unsupportable debt burden. In 1989, public capital expenditures represented about one-third of provincial output, of which identifiable borrowings of around Y 800 million accounted for about 40 percent. Normally, this would give rise to a debt burden, not shown in the province's public finances, of about 15 percent of projected annual fiscal revenues of around Y 600 million, as well as lead to inflationary pressures. This level of government borrowing from the province's banking system would also crowd out lending to the local private sector.

5.11 Hainan's quest for a more market-oriented approach has resulted in one rather unusual tactic for resource mobilization: investment incentives to foreign investors to finance roads, transport and power infrastructure, in return for generous treatment of their profits. This may be partially motivated by the central government's realization, at the time Hainan was made a province, that it would not be able to support Hainan's infrastructure needs as generously as had been possible for the other SEZs in the early 1980s. However, this approach to financing infrastructure, which may result from a confusion between foreign <u>investment</u> and foreign <u>borrowing</u>, does not encourage the types of investment private interests are ordinarily expected to be best at, namely the provision of imported technology and management skills. At the same time, the government and parastatal organizations involved in the one example of this financing to date, the Macun Thermal Power Plant, have offered investment conditions conferring above-normal returns at reduced risk to investors.4/ Normally, the role of private investors in infrastructure development is different: large scale land lease and development schemes such as the Yangpu project; more conventional, through government guaranteed bonds offered to investors by public agencies (such as public utilities); or build-operate-transfer (BOT) projects, a new approach to major infrastructure with revenue-earning potential.

5.12 <u>Central Budgetary Transfers</u>. As with most other poor provinces in China, Hainan's expenditures exceed revenues collected in the province; the collections were Y 756 million in 1989, equivalent to about 8 percent of its

---

4/ Financed by Hong Kong companies controlled by MOFERT and the Bank of China, the Macun financing package guarantees 8.9 percent interest on the investors' US dollar loan for the plant, which was constructed by a Chinese contractor, selected without international competitive bidding, for $70 million.

national income, while expenditures were 19 percent of national income. Until 1988, Hainan received indirect transfers from Guangdong; since then, direct budgetary transfers have been made by the center. There are three kinds of transfers or grants. MOF's "system support" is transferred in the context of China's overall revenue-sharing system agreed in 1984. In 1990, the transfer was Y 171 million, supplementing local collections by 30 percent. This transfer is fixed in nominal terms for the five years, 1991-95. In addition, beginning in 1988, Hainan received development construction funds for capital expenditures, some Y 417 million in 1990, supplementing local collections by another 80 percent. Finally, special grants are given to cover fiscal shortfalls. These totaled Y 334 million in 1989, supplementing local collections by some 60 percent. Taken together, the three types of transfer supplemented local collections by almost 190-200 percent, doubling Hainan's expenditure capacity.

5.13 Budget Deficits Revisited. Table 5.2 recasts the analysis of collections, expenditure and transfers from the central government to show the budgetary position on current account and the role of the central government in financing this deficit. In brief, Hainan has had a current account deficit of some Y 200-400 million annually (line 14) throughout the period under review. Price and other subsidies account for Y 120-260 million (60-65 percent) of this deficit (line 26). These current account subsidies were partially financed, but not fully covered, by central government "system support" transfers, to which Hainan, as a "poor" province, was entitled under the existing system of center-province fiscal relations (para. 5.1). Together with transfers from extrabudgetary funds and unpaid expenditure items (line 18), these transfers left deficits of Y 80-240 million. Additional "ad hoc" transfers or special grants (line 19) provided supplementary funding which covered current deficits and allowed carryovers of Y 19-190 million to the following years (line 24). Capital development transfers from the central government (line 21) brought Hainan's budget into balance (line 25), and coincidentally financed the carryovers. In sum, price, grain and enterprise subsidies have an extremely negative impact on Hainan's budget, and are principally responsible for the deficit on current account. The budget, after all three transfers are included, is not in shortfall. But the Y 260 million burden of subsidies to SOEs, to consumers and for grain in 1989 accounts for a large part of Hainan's difficulties and the need for central transfers, a situation which should be addressed over the near term.

5.14 Extrabudgetary Funds. Extrabudgetary funds refer to funds outside the budget which accrue to (or are spent by) local governments, administrative units, and SOEs and their supervisory agencies. Total extrabudgetary revenue for 1989 was Y 496.5 million, nearly 80 percent of total budgetary collections. Some two-thirds accrued to SOEs, 34.3 percent to administrative units and 2.2 percent to local finance bureaus. Extrabudgetary expenditures amounted to Y 500.6 million (36.7 percent of budgetary expenditure), and was approximately equivalent to extrabudgetary revenue since units cannot spend more than is in their off-budget account. Their distribution favors current expenditures, with capital construction accounting for 18.7 percent, technical innovation 16.7 percent, and welfare/consumption expenditures some 26.6 percent. Hainan has taken some measures to improve the management of extrabudgetary funds. Since 1990, extrabudgetary funds of institutions and administrative units must be deposited in special accounts and are subject to the

Table 5.2: HAINAN: BUDGETARY FUNDS ADJUSTED ACCOUNT
(Y Million)

	1987	1988	1989	1990 (Budget)
1. Sources of funds (2+3+4+5)	480.0	650.0	909.8	874.8
2. Budgetary revenue (Chinese def.)	295.9	482.4	624.8	557.1
3. Transferred from extrabudgetary funds	61.6	71.8	48.9	42.8
4. Planned subsidies to SOEs	67.0	76.7	95.1	87.8
5. Carryover from last year	55.5	19.1	141.1	187.0
6. Uses of funds including subsidies /a (7+10)	739.0	1,000.0	1,472.0	1,620.0
7. Budgetary expenditure (Chinese def.)	672.0	924.8	1,380.9	1,533.0
8. Of which price subsidies	52.0	102.6	161.4	155.1
9. Of which grain subsidies	31.5	25.3	43.6	43.6 /b
10. SOE subsidies	67.0	76.7	95.1	87.8
11. Capital construction	46.9	125.5	246.5	352.4
12. Current expenditures (excl. capital construction:) (6-11)	692.0	875.0	1,229.0	1,268.0
13. "Current account" balance (1-12)	-212.0	-225.0	-320.0	-394.0
14. Memo: Total subsidies	150.0	204.6	300.1	286.0
15. Financing the current account (16+17)	109.4	147.3	162.9	164.6
16. Transfer to CG	(43.7)	(5.8)	(8.2)	(6.5)
17. System support from CG	153.1	153.1	171.1	171.1
18. Balance after current transfers (14-15)	(102.9)	(78.7)	(157.6)	(229.1)
19. Special grant from CG /c	165.5	192.7	334.1	165.0
20. "Current account" balance with special grants (18+19)	62.6	114.0	177.4	(64.1)
21. Development funds from CG (capital transf.)	0.0	127.0	265.0	417.0
22. Capital construction expend.	(46.9)	(125.5)	(246.5)	(352.4)
23. Overall balance after capital transfer (20+21+22)	15.7	115.5	195.9	0.5
24. Carryover to next year /d	(19.1)	(141.1)	(187.0)	0.0
25. Net balance (23+24)	(3.4)	(25.6)	8.9	0.5
26. Memo: Total subsidies (8+11)	119.0	179.3	259.2	242.9
27. Memo: Total subsidies to grains (9+12)	76.0	68.5	90.3	90.3
28. Memo: Grains subsidies as % of total subs.	63.9	38.2	34.8	37.2
29. Memo: Total subs. as % of tot. cur. exp.	17.2	20.5	21.1	19.2
30. Memo: Current account excl. tot. subsidies (14+25)	(93.3)	(46.7)	(60.4)	(150.8)

/a To approximate expenditures by IFS definition.
/b Assume that subsidies in 1990 are projected to remain at 1989 levels.
/c Derived from HPG's budget reports presented to Hainan People's Congress, various years.
/d Adjustments were made to make figures consistent to line 5. Original figures from DFT were shown as follows: 1987: 23.8; 1988: 115.9; 1989: 187.

Source: Mission estimates derived from HPG's statistics. Figures for 1990 are derived from HPG's 1990 budget report presented to Hainan's People's Congress, April 1990.

supervision of local or provincial finance offices. For SOEs, similar controls are in place, although when SOEs are separated from the provincial budget and subjected to a hard budget constraint, the current artificial distribution between enterprise "budgetary" and "extrabudgetary" items could usefully be dropped. SOE extrabudgetary outlays are to be directed towards productive (capital construction and renovation) rather than nonproductive (consumption) expenditures. Available data do not confirm that these controls have been successful. Current government accounting practices provide no

mechanism to integrate budgetary and extrabudgetary funds under a unified system, even though the provincial finance authorities are supposed to oversee both types of funds.

B. Recommendations for Fiscal Reform

5.15 As seen in its fiscal projections recognizing that revenues must grow at a much higher rate than expenditures over the next five years, HPG is aware that its main public finance challenge is the reduction of its budget deficit. The deficit should be brought down to a level commensurate with the likely sustainable--and probably declining--volume of central government support, and within prudent debt service limits for official borrowing with PRC guarantee. In projecting that fiscal revenues must grow at a much higher rates than expenditures over the next five years, HPG has acknowledged this imperative.5/ A reclassification of broad public finance statistics suggests steps on both the revenue and expenditure fronts to narrow the present large gap, now met by central government recurrent and capital support.

5.16 On the revenue side, broadening the tax base and increasing tax collections through strengthened tax administration should be a high priority. Since Hainan retains most taxes raised in the province, there are immediate gains to be had from increasing collections. Hainan should continue its ongoing tax administration reform (the "three separations" of assessment, from collection and audit) and strengthen its tax collection system. The current decentralized and fragmented system has inevitably allowed the government's administrative units to interfere in tax assessment: a single, clear chain of responsibility for tax collection would remove the possibilities for discretionary treatment. Simplified tax forms and reporting frequency would reduce the administrative burden on Tax Bureau staff and enterprises alike. Separation of enterprise taxation from the contract responsibility system would be a good first step in making tax policies compatible with a market-oriented economy. Preferential tax treatment, which encourages creative accounting and tax avoidance, should be tightened to close possible loopholes. As labor markets become freer, personal incomes will increase and show wider distribution. Hainan may wish to experiment with a simple and initially very low personal income tax covering wage earners, and gradually extend it to other forms of income (including realized capital gains and interest and dividends). Finally, as in other market-oriented economies, detailed tax and other relevant statistics should be made available both within government and to the public in order better to frame and implement fiscal policies.

5.17 On the expenditure side, reduction of subsidies and control of administrative costs are obvious steps. As an SEZ, Hainan's "small government" policy is meant to allocate public sector resources efficiently to help develop a market-oriented economy. However, in the years since achieving provincial status, Hainan's current expenditures rose in three areas: civil service costs and price and SOE subsidies. With respect to personnel, only those units whose functions are necessary to promote or regulate the market

---

5/ Governor Liu Jianfeng, "Report on the Eighth Five-Year Plan and 10-Year Development Plan" to the Hainan People's Congress, May 6, 1991.

should be allowed to expand. Hainan should undertake a comprehensive Public Expenditure Review, to reevaluate the functions of each administrative unit, its functions, and the resources (for staff, operation, and maintenance) it requires. Once the size and duties of the public sector are defined, Hainan should introduce a budgeting system that separates recurrent and capital expenditure and operates as a management tool for the provincial authorities.

5.18 Improved Management of Extrabudgetary Funds. The management of extrabudgetary funds also needs to be strengthened. Budgetary and extrabudgetary funds should be consolidated and reviewed together, so that resource mobilization and allocation are more efficient and globally coordinated. Many enterprises and government units supplement their budgetary resources with off-budget revenues from user charges or sideline activities. Where non-SOE units are clearly revenue-earning, their fees should be set to cover the costs of the service (e.g., hospital charges) and subject to suitable accounting rules. Where the service provided is less suitable for direct charges (e.g., primary schools), the rationale for such extrabudgetary charges should be clear and sideline activities undertaken purely to raise off-budget funds should be subject to explicit justification.

5.19 Subsidies to Consumers and to State-Owned Enterprises. The gradual removal of subsidies to loss-making SOEs and elimination of price subsidies would close a large part (81 percent) of the current budget gap. In particular, price subsidies and subsidies to commercial grain enterprises, now accounting for 63 and 18 percent of total subsidies respectively, and 15 percent of total expenditures, should be eliminated and replaced by targeted and less costly welfare payments for needy urban residents. Hainan has taken positive steps to decontrol grain and other prices. By implementing these price decontrol measures, Hainan should be able to reduce its budgetary shortfall and strengthen its fiscal position. As part of enterprise reform, the government should have SOEs perform according to a clear set of rules and without day-to-day administrative oversight. The banking system should provide credit. Enterprises which cannot operate without subsidies and cannot repay loans, should, with suitable transitional arrangements, be closed down.

5.20 Intergovernmental Fiscal Relations. Since becoming a province, the energies of Hainan's government bureaus have been concentrated on dealing with central line ministries to obtain additional funds for specific capital projects,6/ while HPG finance officials have sought supplemental support to cover the current deficit. Allocation of expenditure and tax functions is one of the most fundamental issues in a country, like China, with multiple levels of government. Decentralized decision-making, which seems to be Hainan's goal as part of its "big society, small government" principle, can be justified on efficiency, accountability, and manageability grounds. Local provision and decision-making allow greater responsiveness to local concerns and needs. It eliminates multiple layers of jurisdiction, a problem with the current rela-

---

6/ Precedent exists in Guangdong and Fujian, which in 1980, received block grants that consolidated all funds available from line ministries, with agreement that no additional funds would be given. Requesting additional funds from line ministries again, they destroyed the spirit of the block grant experiment.

tionships between the center and HPG and acknowledged in both Beijing and Haikou. In a country as disparate as China, however, the authorities will wish to emphasize diversity in public services, achieving minimum national standards by transfers to poorer areas like Hainan, and harmonization of taxes.

5.21 MOF has indicated that a block grant system for Hainan might be appropriate once expenditure controls are in place. A block grant that consolidated all transfers and subsidies from the central government would eliminate the need to negotiate with the center, be consistent with "small government" objectives, and encourage Hainan to take responsibility for its overall development effort. It would also reduce involvement of the central government in goal-setting and economic decision-making so that Hainan could better respond to the market economy. In arriving at any block grant arrangements, both the central government and Hainan will wish to take account of the net transfers implicit in the current Plan allocation and pricing mechanisms, as well as China's transition away from these aspects of a command economy. These include indirect taxation of grain through procurement quotas, subsidies to Hainan's state farms through above-world-market price procurement of rubber, subsidies to iron ore users outside Hainan through the less-than-world-market price received for iron ore, and subsidies to users of Plan-allocated steel, cement, coal, petroleum products, timber, fertilizer, pesticides, and other materials. In future discussions of the level of central government aid to Hainan, HPG should calculate this balance and the implications of converting to a full market system where distorted prices are replaced by fewer and well-targeted interventions. However, it will be difficult for Hainan to move to a competitive economy with the market determining resource allocation, no matter what ownership models are adopted, as long as a pervasive set of externally determined price and quantity decisions is set for its main products.

5.22 Although capital infrastructure financing is now shared between levels of government, Hainan may wish to experiment with greater separation of responsibility depending on the nature of the public investment and the area served. To improve the utilization of cultivated rural land, the province may wish to impose land use fees and taxes that could be used to finance rural roads and water supplies, and to contribute to schools and village clinics. Subject to the outcome of broader discussions with the center, it might also be possible to bring the state farms into the provincial/local system of taxation and expenditure. While some of these user fees are perhaps appropriately levied (and spent) at the local level, a broader tax base might improve the equity of provision of some of these services. In urban areas user fees and possible land use, property and business taxes could finance the provision of economic infrastructure necessary to promote investment in commerce and services (including housing) and assure a safe and comfortable standard of living. Consistent with national goals for the distribution of personal income, Hainan might wish to pilot personal income tax on wage, salary and benefit income, followed by taxation of interest, dividends and capital gains.

5.23 To regularize fiscal relationships between HPG and local governments, Hainan should also proceed with plans to establish revenue allocation formulas with lower-level governments so that the government at each level can function better. Currently, despite the fiscal contract system, lower-level governments in Hainan come to the provincial government for support and subsi-

dies. Block grants that take into account poverty and the counties' disparities in revenue potential could simplify and regularize these intergovernmental transfers, so that greater effort could be made to plan and monitor spending according to well-conceived priorities.

5.24 The Role of Foreign Borrowing. Hainan's overall infrastructure development will depend in part on foreign borrowing. As in all provinces, external borrowing is, quite correctly, controlled by the central government through SPC, PBC, and SAEC. It is important that Hainan explicitly follow the center's guidance in this, and that it establish a debt management strategy and system to assess Hainan's debt service capacity and manage its external debt and repayment. While Hainan Province relies on central government guarantees for its overseas borrowing, the ensuing debt service will eventually appear in its own budget.

5.25 Conclusions. The budget reforms discussed above alone will not close Hainan's revenue-expenditure gap. While they will make the public sector more efficient and enhance its effectiveness, unless private sector development yields tax revenues much more quickly, there will be a shortfall for the foreseeable future. Hainan will continue to need transfers from the central government. As a poor province, and assuming it maintains its own efforts at revenue collection and expenditure control, the continuation of such transfers--especially in the block grant form, perhaps based on a "matching requirement" to encourage local revenue effort--is appropriate.

C. Financial System and Policies

5.26 Hainan's financial system development parallels that of China. All four specialized banks are represented in the province, and have been reorganized in line with the nationwide financial sector reforms of 1979-85. Beginning in 1988, Hainan implemented "special financial sector policies" to develop new financial institutions. By the end of 1989, Hainan had 1,065 bank branches; 25 trust and investment companies (TICs); 12 urban credit cooperatives (UCCs); and 753 rural credit cooperatives (RCCs). There were two agencies of foreign banks and 14 financial institutions from other provinces.

5.27 All four national banks (and the Bank of Communications which has recently set up branches in Hainan) are allowed to engage in foreign exchange transactions. Five TICs are also authorized to do so. Since October 1987, a number of Foreign Exchange Adjustment Centers have been established, with some $200 million exchanged in 1,006 transactions in 1988, and $287 million in 1989. The financial sector also engages in leasing, equity investment, trusts, and stock brokerage.

5.28 Major financial sector issues relate to soundness of the banks and the respective roles of, and better supervision of, banks and nonbank intermediaries. As in other parts of China, Hainan's financial sector continues to be used as a supplemental source of "public sector revenues" with confusion between the roles of the budget and the financial system, and credit directed by the government in accordance with the Plan. Government direction of credit --not always to creditworthy borrowers--has depleted the capital of financial institutions; their liquidity is also low, owing to the large proportion of overdue loans to loss-making SOEs.

5.29 Financial Structure. The balance sheet structure of Hainan's intermediaries reflects the changing structure of the local economy. With the expansion of nonstate activities within the banking system, township and rural deposits have grown most rapidly, to more than half of total deposits in 1989/90. Banks' enterprise loans are mainly for working capital and for commerce and service activities, with capital construction loans accounting for only 1-3 percent during 1987-89. Within the financial sector more generally, TICs expanded rapidly: their loans grew to reach 18.1 percent of financial sector assets by the end of 1989. This growth in TIC lending activity was facilitated by financial inflows from mainland provinces, which provided a total of Y 0.35 billion in 1989, of which Y 0.29 billion through 12 TICs.

5.30 Financial Performance. Hainan's specialized banks fund their loans mostly from their own capital and deposits, but are increasingly reliant on ad hoc borrowing from their own headquarters or from other sources, including interbank borrowing of Y 0.4 billion from PBC to meet loan demand or liquidity shortages.7/ (RCCs are, by contrast, able to fund loans from deposits and other liabilities.) Hainan's banks are also highly dependent on credit allocations from PBC. Credit flows within the province are thus influenced by PBC and the specialized banks' direct transfer of funds to or from their respective branches in Hainan. A major performance issue relates to portfolio quality. A serious concern relating to both banks and TICs is the growing amount of overdue loans, amounting to an estimated Y 1.9 billion, 19 percent of specialized banks' loans outstanding. Overdue borrowers include grain companies, enterprises with large inventories and "cross debts," and loss-making SOEs. Most TICs do not have sufficient capital and deposits to fund their loans and, like banks, rely on ad hoc borrowing from PBC, other banks, and other sources to meet largely unscrutinized loan demand. In 1989, TICs' total loans of Y 1.4 billion were funded by deposits (39 percent), own capital (40 percent), and ad hoc borrowing (20 percent of total assets). TICs' overdue loans reached 13 percent of outstandings in 1989.

5.31 To improve financial management, PBC's Hainan branch initiated an inspection of all TICs and UCCs in 1989. Excessive and imprudent lending practices, insufficient capital, heavy reliance on ad hoc borrowing, and high interest rates (sic) were cited as major problems. To strengthen the financial condition of the TICs, capital requirements will be raised from the current Y 20 million to Y 50-100 million. PBC would also seek to strengthen banking sector management and personnel, though beyond vague plans for a new training institution in the province, specific measures have yet been drawn up.

5.32 As elsewhere in China, the root of the banks' difficulties lies in the enterprise sector. Without reforms to improve the management and efficiency of SOEs, banks will be pressed to offer directed credit detrimental to the banks' profitability. Similarly, grain companies, weakened by price controls, continue to drain resources from the banking system. While regulations

---

7/ For a general discussion of credit planning in China's financial sector, the role of the monetary authorities, and other relevant issues in China, see China--Financial Sector Review: Financial Policies and Institutional Development, World Bank Report 8415-CHA, June 29, 1990.

permit transfer and mortgage of land and real estate in Hainan, financial markets that would fully take advantage of these possibilities do not yet exist, and PBC (Hainan) has not yet developed its regulatory abilities in this area. Finally, there is little separation between fiscal revenues and advances to the public sector from Hainan's banks. This continued confusion over the respective roles of the fiscal and financial systems should be clarified if banks are to be more soundly managed.

5.33 Block Credit Management. Like other provincial branches, PBC Hainan is subject to national credit planning and policies set by PBC Headquarters. However, State Council Document 24 envisaged a curiously autonomous role for PBC's Hainan branch. It states that "Hainan's credit planning will be implemented by the PBC-Hainan in the form of 'block management'." Based on this, Hainan has requested a "block credit management" package to accelerate its financial sector development (Box 5.1). Not all of these measures have been implemented since PBC has taken the view that Hainan's conditions are "not yet ripe." However, Hainan expects to continue to get special and preferential treatment in the implementation of national credit policies. The proliferation of small enterprises and trading companies (Chapters 2 and 3) has expanded demand for credit; under existing national policies and practices, supply of funds and regulatory abilities in Hainan have not matched this pace.

Box 5.1: HAINAN'S "BLOCK CREDIT MANAGEMENT" REQUEST

1. All credit funds PBC allocated (i.e., *loaned*) to Hainan before 1988 would not be transferred back to the mainland. STATUS--de facto implemented.

2. All deposits except for the fiscal deposits (i.e., money collected by local governments that must be deposited to national banks) should be retained within Hainan, presumably to be placed with other financial institutions. STATUS--monetary aggregates show some volatility, implying flows in and out of the province.

3. Hainan's bank lending should not be subject to the lending quota negotiated with/determined by PBC; rather, it should be subject to a "more flexible form depending on the needs of Hainan's development." STATUS--quotas to Hainan appear more liberal than elsewhere during post-1988 austerity period.

4. From 1988-95, the PBC would allocate Y 200 million per year to Hainan as low interest development loan, while the Bank of China would allocate a $50 million per annum foreign exchange loan for five years (according to Document 24). STATUS--apparently implemented. Issue is uses to which this credit is put and how it is allocated.

5. Hainan should not be burdened with the sales of national construction bonds, i.e., HPG should not be responsible for distributing the bonds, which imposes an administrative burden on the banks as they have to apportion the bonds among many economic entities who must use cash reserves to buy them. STATUS--apparently implemented.

6. Hainan should be exempt from submitting required reserves to the PBC; instead, the reserves should be retained by PBC's Hainan Branch only. STATUS--not implemented.

7. PBC's Hainan branch would have the right to determine interest rates except for those loans from PBC to the national banks. STATUS--not implemented.

D. Recommendations for Hainan's Financial Sector

5.34 Supervision and Regulation. Consistent with measures now under way at the national level, lending policies of banks in Hainan should be reviewed to detect bad loans, especially bad policy loans: banks operating in Hainan should make adequate provision for loan losses. These are national financial sector issues that should apply throughout China, but in Hainan, with its market orientation, early action by PBC and MOF respectively would be desirable. PBC Hainan should also pay more attention to the management of nonbank financial institutions, especially TICs. Without proper supervision, these financial institutions might operate outside prudent banking norms; indeed, some of them were set up by specialized banks and other provincial governments specifically to avoid strict banking supervision. While PBC wants to create a flexible environment to enable them to experiment, better management, regulation and supervision are needed to protect the stability and reputation of Hainan's financial sector. Training of PBC staff in banking supervision and audit, and of financial institution staff in accounting, risk analysis and project appraisal is also important.

5.35 Credit Policies. Hainan's economy remains dominated by the public sector, its financial markets are still rudimentary, and its reliance on PBC and specialized bank credit imply little scope for immediate autonomy. Hainan, as an SEZ, should be allowed to develop market-driven and relatively autonomous credit policies to promote the development of a market-oriented economy. The block credit management package requested by Hainan may be a solution once PBC's Hainan branch is capable of supervising financial policies independently and effectively, though as part of China's financial system Hainan would of course be subject to reserve requirements designed to ensure sound national monetary management. PBC's view is probably correct that conditions are not yet ripe for block credit management in the form proposed by Hainan, particularly before interest rates are broadly set by the market. In the spirit of Hainan's reforms, PBC might therefore wish to allow credit in Hainan to be allocated by sectors and among creditworthy customers not as directed credit passed down from the specialized banks' headquarters, but according to market-set interest rates that reflect customer risk and resource availability in the province.

E. Authority and Policy

5.36 In recent years, nominal increases in revenue have barely kept pace with prices and incomes, while expenditures have grown significantly in real terms due to large increases in capital expenditures, public administration and employment, and subsidies to consumers and loss-making SOEs. Much of the deficit has ended up in the banking system. Well-designed, efficient infrastructure, constructed and financed by the public sector, will be needed to create the conditions under which market-oriented reforms will take place in Hainan. But the burden of expanded government, and in particular of consumer and SOE subsidies, is difficult to justify in the context of "small government," and the marketplace. It may be consistent with practice in much of China. But it is not compatible with Hainan's goals of reform, its sought-after disciplines of efficiency and competition, and expenditure priorities which should be elsewhere--objectives which are accepted at the political

level (para. 5.15) and now need translation into government programs and priorities.

5.37 In continuing, in practice, to finance these deficits--in spite of declared intentions to hold financial support to Hainan constant--the Ministry of Finance has in effect applied a "soft budget constraint" to the province. Correspondingly, only central determination can be expected to impose a reversal of the recently escalating deficits, through the hardening of the same budget constraint. It seems clear, in any case, that the trends of the recent past cannot continue indefinitely, and that Hainan's government must thus give early attention to measures to reduce its existing level of deficit spending. Strict adherence to the "small government" principle implies retention of only those government units whose functions are necessary to support, promote, or regulate a market economy. Action on grain has begun; other subsidies should be reduced and eventually eliminated. Hainan's lead in raising grain prices should be followed by early moves to liberalize and fully deregulate other markets and eliminate, through competition, the subsidies to grain SOEs involved in distribution. Extrabudgetary funds need to be integrated into the regular expenditure review process. In the area of public investment, Hainan needs to apply greater selectivity in distinguishing those spheres of activity where public sector involvement and funding are truly justified on "public goods" grounds, rather than entering into productive sector activities and investments more appropriately handled by the private sector. Infrastructure projects supporting private investment already firmly committed should receive priority. This would imply a continued geographic focus on Haikou, Sanya, and Yangpu, which eventually could yield local tax revenues through levies on land use and occupancy.

5.38 In considering how, more effectively, to apply a hard budget constraint to the province, the central government needs to bear in mind both its own volume of budgetary support, and the province's capacity to borrow--whether from the domestic banking system (including indirect borrowing through SOEs) or internationally. On the basis of a thorough Public Expenditure Review, the former control might appropriately be applied by setting in advance a strict aggregate limit to the total amount of budgetary support that will be provided, and permitting no subsequent adjustments or exceptions. Such an arrangement might not be easy to achieve, as it could potentially cut across the authority of numerous central agencies which currently control (or withhold) spending programs in their own sectors, and with which corresponding provincial agencies are accustomed to dealing. Time would in any case be needed to put in place satisfactory alternative mechanisms for expenditure monitoring and control. Among the various models of intergovernmental fiscal relations that China might examine, a possible longer-term objective for Hainan might be to operate a "block grant" system which would permit the province greater autonomy to determine its own spending priorities, while reducing the detailed intervention of central sectoral agencies in the province's goal setting and economic decision-making. Straightforward fiscal arrangements along these lines could provide a model for broader fiscal reform in China, while giving Hainan the autonomy it needs to proceed with its own ambitious reform agenda.

5.39 As noted above, the domestic financial sector and foreign borrowings are also relevant to Hainan's overall fiscal position and its ability to pro-

ceed with broader reforms. To remain within the limits set (appropriately) by central authorities (SPC, PBC, SAEC) on foreign borrowings, Hainan needs to establish a debt management strategy and a system to assess its debt service capacity and to manage repayments. On the domestic front, one of the major challenges for the People's Bank of China (PBC) in Hainan is that, at present, there is little separation between fiscal revenues and advances to the public sector from Hainan's banks. The confusion over the respective roles of the fiscal and financial systems must be clarified both to achieve fiscal balance and to permit banks to concentrate on their roles as intermediaries (rather than fiscal agents) and re-establish acceptable standards of prudential management. Related to the above, the root of the banks' present difficulties comes back to the state enterprise sector: without progress in SOE reform, banks will continue to be pressed to provide directed credit to the detriment of their own profitability. This is an area where Hainan's experiences in reform could be relevant to other parts of China.

VI. CREATING THE CONDITIONS FOR DEVELOPMENT

6.1 This chapter attempts to summarize the key policy issues facing Hainan in its development process during the 1990s. The challenge facing Hainan is to shape its current structure of development--a mix of urban and rural, state-owned and private productive activities, a rapidly growing outwardly-oriented sector dominated by state companies from other provinces, and a state farm sector producing rubber and other tropical crops--to its future goals. How successfully it does so will affect whether it remains a poor, remote and somewhat backward province; takes advantage of its Special Economic Zone status, conferred in 1988 when it became the only SEZ that is a province; or becomes the laboratory for reform envisaged in late 1987-early 1988 by its founders and its promoters in the central government, and by its political leadership today.

6.2 Earlier chapters have described the status of reform in Hainan by mid-1991, and outlined some of the ideas that have been advanced for moving forward. The vision of Hainan as a reform laboratory remains vague, however. Realizing the province's potential, once it is realistically assessed, will depend on identifying a clientele for the specific reforms proposed and greater involvement, interest and awareness by the major economic actors in the vision of a market-oriented economy in Hainan as a model for reform elsewhere. The state farms, the iron ore company and the provincial officials responsible for public infrastructure investment or SOE management, as well as officials of central government core and line ministries, will look to Hainan's experience as models for national legislation and practice applicable throughout China. They will all need to share this vision. As noted in Chapter 3, many of Hainan's existing powers to promote investment and trade are not being exercised, owing mainly to bureaucratic red tape at the central government level (largely MOFERT, but also SPC). This "nonoperational situation" may be justified in part by the austerity program in effect in China from late 1988 to early 1992, imposed barely six months after Hainan became a province with fairly explicit powers conferred by the State Council. During the austerity period, the central government seemed to have become much less favorable to the high degree of provincial autonomy implicit in Hainan's legal authority (Documents 24 and 26 of the State Council, issued in early 1988) and, despite Hainan's severe financial deficit situation (Chapter 5), did not appear disposed to be much more helpful in moving in the directions Hainan is, on paper, supposed to go. Once the political commitment for reform is agreed between Beijing and Haikou and articulated, with clarity and determination, it will then be necessary to reach consensus at the bureaucratic level and agree on steps toward implementation, including measures to reinforce the provincial and local administration.

6.3 Clarification of Hainan's Legal Autonomy. There remains some confusion over the exact degree of autonomy Hainan enjoys. State Council Documents 24 and 26 offer only partial guidance. They envisage a continued request/approval relationship between Hainan and line ministries in Beijing over matters of investment, trade and economic policy. And their application in practice appears to be at odds with the expectations of senior officials and civil servants in Hainan. This has also resulted in confusing signals to the investor community. In order to improve the climate for investment, particularly

for foreign capital, the central government needs to clarify the extent of Hainan's autonomy over investment, trade and taxation; and, against this background, to redefine the role of MOFERT in approving export and import quotas, the role of SPC in approving investments, particularly those involving foreign capital, and the procedures to be followed at the provincial level. Hainan cannot sever its ties with the rest of the country, however experimental or reform-oriented its policies. Some of the more far-reaching proposals, such as a separate currency, must be evaluated in this context.

6.4 The Framework for Market Development. Enacting legislation defining property rights and contracts, and putting appropriate judicial procedures in place would be an important first step. A sound, transparent, and efficient legal framework would reinforce market-oriented trends in the province. To encourage smallholders and larger ventures to invest in upgrading agricultural land, Hainan should in particular review and simplify procedures for land rights and establish principles clarifying the legal and regulatory basis for "ownership." A land registration and transfer procedure consistent with these principles should be designed and introduced. This would also allow reform of agricultural taxation to a broad, nondistorting basis, on the productive value of land, with the elimination of grain procurement quotas--a form of tax on farmers--and the multiplicity of other rural charges and levies. For nonagricultural ventures, particularly in industry, many see a customs zone and a separate currency as prerequisites to promote investment and exports, because (and although) the current, nominally favorable regulations are not being implemented fully. It is difficult, however, to envisage a more favorable formal investment climate in Hainan, given its similarity to, and slight edge over other SEZs and coastal cities, including Pudong. Indeed, Hainan's investment climate is likely to remain less than optimal without a more liberal application of its current investment regulations, and without a properly applied legal framework. In addition, a rapid implementation of the foreign investor funded aspects of Yangpu Project (a large-scale development zone of serviced industrial sites, to be built and operated by a foreign company) would be a concrete demonstration of China's intentions to promote Hainan's market-oriented development. Proceeding quickly 1/would also relieve the provincial government of the financing burden of creating modern and reliable investor services and infrastructure.

6.5 Liberalizing Trade and Investment. Unlike export processing zones in other developing countries, two of China's SEZs, Shenzhen and Xiamen, have over the 1980s experienced all-round growth in industry, agriculture, tourism, science and technology, and culture. While Hainan may not have the locational and historical advantages of the older SEZs (and their 10-year head start), it has a strong agricultural sector, and mineral and ocean resources that offer attractive investment and trade opportunities--and thus more broad-based development prospects--than these other, geographically more limited SEZs. The overall impact of Hainan's already very attractive incentives would depend on the nature of the investment, and in particular the payback period sought by the investor. International experience shows that lengthy tax exemptions may have little impact on an investment decision, especially if the investor plans to make profits and return on investment early in the project's life.

1/ The letter of intent was signed in March 1992.

In this case, stability of policy and predictability of its implementation have greater impact on the project's cashflow, and the freedom to produce quickly for the intended markets weighs more heavily in the investor's decision whether or not to locate in Hainan. MOFERT's export quotas and their allocation constrain Hainan's trade. This limits Hainan's potential to take advantage of lower wage costs and the intended incentives of its trade and investment regime. Several well-publicized examples involving foreign investors (shrimp farming, silk textiles) suggest that, at least in the affected sectors, the preferential policies in Hainan's legislation have been largely inoperative because they were not applied as written, even after the investors had completed construction and production was scheduled to begin. By making the rationale for the current commodity coverage and application of active export quotas clearer and more competitive, the central government could enhance the attractions for foreign investors. It should also develop alternative means of allocating passive quotas to producers in different provinces in a more equitable and transparent fashion, such as by auction, that would allow entry by more efficient, new producers into China's export markets. Quotas should then be reallocated periodically by these same procedures.

6.6 Thus, once the center clearly defines Hainan's legal powers, the province should act to put in place simplified investment and trade approval processes. These should offer the investor greater freedom from import, export and foreign exchange restrictions and a priori controls and approvals, and reshape incentives toward investments that will generate employment and increase local value added. At a minimum, Hainan should alleviate investor anxieties about doing business in the province by transforming its Investment Commission into a one-stop investment approval agency and seeing that the foreign exchange adjustment centers operate in the fully-open, freely-accessible manner intended.

6.7 A Strategy for Public Investment. The 1990s are likely to see continuing debate in China on the role of the Plan and the exact meaning of the "planned commodity economy, combining plan and market." Markets now account for close to half of all transactions in China, and, excluding its rubber and iron ore sectors, probably a good deal more in Hainan. Changes in Hainan's approach to public investment and "planning" could place it in the forefront of economic reform in China.

6.8 Hainan should examine its planning process, with a view to drawing up a Public Investment Program (PIP) and financing plan focusing on infrastructure and other public services such as education. It should also draw up complementary regulatory and pricing policies that would create a more favorable environment for private investment to take advantage of this infrastructure and generate the revenues to finance it, rather than entering into productive sector investments more appropriately handled by the private sector, or unconventional infrastructure financing mechanisms. Implementation of a rolling, three-year PIP is one approach that would allow Hainan to give greater consideration to resource constraints and financing availabilities in the determination of PIP priorities.

6.9 Government as a Producer. The small scale of Hainan's industrial and commercial SOEs, and the favorable conditions for both foreign and domestic investment, may also allow broad experiments in enterprise reform. These

might include privatization of some of the smaller ones. A single agency should consolidate SOE oversight and audit functions from their current dispersal among sectoral bureaus, which have a tendency to blur the current management and ownership roles of government. In particular, the contract responsibility system, enterprise accounting and the taxation of SOEs should be put on a consistent and uniformly applied basis. HPG should then examine the role and powers of existing provincial and local bureaus and departments (and gradually shift them into) to see that they play a regulatory role consistent with a market-oriented economy. In particular, units responsible for consumer protection, promotion of competition and enforcement of environmental regulations should be created and suitably staffed.

6.10 The government bodies responsible for iron ore and rubber, the Hainan Iron Ore Company and the State Farms Bureau, offer creative possibilities for restructuring the role of the government. While the iron and steel sector in China is likely to remain under State control for the foreseeable future, restructuring the Iron Ore Company need not imply a shift to nonstate ownership. It might, however, involve issuing shares to the central government, HPG and the major steel producers who are consumers of the company's ore, and using China's Enterprise Law and other relevant regulations to separate the relationship between the company's owners, management, and workforce. Its management needs to establish the economic and financial viability of any additional investments, including Eighth Five-Year Plan proposals to build a small steel plant (and additional dedicated railway line) to use existing low-quality, waste ore. The environmental consequences would need to be fully reviewed, and any negative impact mitigated through careful design and proper operation of steel-making facilities. Involvement of a foreign joint venture partner in a small project to use inferior grade ore would depend on the economics of the project.

6.11 Domestic natural rubber production accounts for less than 30 percent of China's total rubber consumption. Land for expansion is limited in Yunnan, China's other major producer, and even with more economic use of rubber in industry (e.g., automobiles), China's demand for rubber will grow. Should the future of rubber production in Hainan be reasonably certain, it would seem logical to evaluate locating some of China's rubber-using industries in Hainan, provided energy requirements and transport to final mainland users and overseas clients could be organized. Again, this would seem an interesting area for promoting foreign private investment.

6.12 The Social Safety Net. Consistent with efforts to move toward a market-oriented economy and encourage enterprise reform, Hainan is proposing extensive reforms in social security, pensions, unemployment and health services to ensure that the social safety net is put in place as soon as possible. Early action along the lines decided should continue, so as not to paralyze concrete measures for public enterprise reform, divestment and, where necessary, closure. In revising provisions for old age security as part of the "socialization" of pensions away from enterprises, the province may wish to promote the introduction of other vehicles for personal savings that would encourage families to supplement their basic, publicly-organized security benefits (to which they, as well as their employers, would have contributed). These might be integrated into greater efforts to mobilize savings in the local banking system through the introduction of retirement savings accounts

and asset-backed investments. In this regard, the divestment of enterprise responsibility for housing might offer one form of investment that urban residents would find most attractive. Hainan should investigate its local housing markets and steps to relieve enterprises and employers from responsibility for the construction and maintenance of housing, along with rents that would encourage further private investment in housing construction and finance. It should design experiments in housing reform, taking account of experience elsewhere, in south China and Hong Kong, and the development of nonstate housing that already seems to have taken place around Haikou.

6.13 Human Resource Development. Hainan's long-term prosperity will depend on expanding literacy so as to have a skilled workforce, and, by attention to the training of girls and minorities, reduce poverty in the province. Hainan faces many of the building and equipment problems schools experience in other poor areas of China. While the desirability of government-financed expansion of specialized vocational and technical training has been questioned in China and elsewhere, the province plans to construct twenty-two 800-1,000 pupil vocational secondary schools during the Eighth Five-Year Plan period (1991-95). However, international experience shows that general secondary education is more valuable as it provides flexibility. An option worth exploring is further encouragement of proprietary technical schools. These "for profit" schools are more responsive to market feedback, and far cheaper, than government technical secondary schools. Such a strategy would avoid transferring scarce resources from basic and general secondary education, (which have the highest social and economic returns) and minority education, where Hainan acknowledges it still needs to make improvements.

6.14 Fiscal Discipline. Central government subsidies have financed Hainan's capital construction program and increasing deficits, despite the announced intention to stay within the agreed framework of decreasing capital and recurrent support (first for 1988-90 and then for 1991-95). In effect, Hainan has been given a "soft budget constraint." This trend cannot continue. After a review of expenditure priorities in the context of a "small government," and in parallel with measures to control outlays, Hainan should take advantage of the growth of the nonstate sectors in its economy to broaden its revenue base. The simplification of the tax system, separation of enterprise taxes from the contract responsibility system, and strengthening fiscal planning should be continued, and possibly extended in three areas. First, Hainan should replace the current two-track system of corporate taxation (pre-1988 and post-1988 firms) by the 15 percent uniform corporate tax rate with limited, narrowly defined deductions which would reinforce efforts to create a level playing field for old and new, state and private enterprises. A uniform tax law would also narrow the scope for negotiation of tax payments by SOEs and their supervising units. It would complement efforts to strengthen tax collection and enforcement. Even-handed treatment also calls for uniform and equitable enforcement of other taxes, such as Industrial and Commercial Taxes (ICTs), and closing of loopholes which might give unintended preferences. Second, the definition and management of extrabudgetary funds should be tightened. Treatment of enterprise and government unit revenue-earning activities as separate cost centers, and introduction of accounting measures conforming to international generally accepted accounting practices, should allow greater transparency in the budget process, and prevent cross-subsidization of public sector activities by commercial functions. Third, freer labor markets have

already led to greater variations in personal income in Hainan than are visible elsewhere in China. For distributional reasons as well as to broaden the tax base, Hainan may wish to introduce a simple and initially very low personal income tax, starting with wage earners, covering compensation and benefits, and gradually extending it to other forms of cash income (including capital gains and interest and dividends).

6.15 However, even these measures will not close Hainan's public sector deficit. Central government financing for the Hainan experiment is likely to remain necessary beyond 1995, when the current arrangement ends. A central government block grant system of budgetary support to Hainan, based on appropriately defined public expenditure priorities and adequate tax effort, would encourage prudent and consistent economic management in Hainan. It would correct some of the planning distortions the current fiscal relationship with the center induces. Removing the central line agencies' authority over expenditures in their own sector would relieve HPG of the time and effort it presently spends seeking Beijing's approval for various recurrent and capital outlays. However, this fiscal autonomy by hard budget constraint would need to be accompanied by clearer expenditure priorities and better expenditure control than now seem to exist in Hainan. After a thorough Public Expenditure Review, budgetary control could be applied by setting a firm limit on total budgetary support MOF would provide. This would be the basis for block grants to the provincial government. These fiscal transfers should also take into account net transfers to the province implicit in the current Plan allocation and pricing mechanism, on account of what Hainan sells to the mainland and the domestic raw materials, intermediate and consumer goods it obtains. The provincial government may wish to undertake the accounting to establish this balance and the implications of converting all Hainan's economic relations with the mainland to a full market system.

6.16 Financial Sector Integrity. Different principles and approaches would be appropriate in a noncommand economy, where credit and foreign exchange are not administratively allocated. Hainan's banking system should be made more autonomous and its credit policies guided by PBC's national monetary strategy. Directed credit should be gradually eliminated to help ensure the solvency of Hainan's financial institutions once enterprise reform is undertaken. Furthermore, the agency functions of banks in Hainan should be clearly separated from the activities undertaken at risk to their owners' capital and on their own management's authority. Steps might also be taken to raise capital requirements for all financial institutions, given the large and potentially dangerous gaps between their assets and liabilities. In addition, the PBC's Hainan branch would need to take greater responsibility for prudential supervision of banks and nonbank financial institutions.

6.17 "Small (and Better) Government." To achieve its goal of outward-oriented development with comprehensive reform, Hainan will need to seek decentralized responsibility for basic expenditure and investment decisions, in agreement with the central government. The emphasis should be on the principle of "small government, large society." Local government in particular appears still to be modeled on the old structure: it needs to be focused on services that can be provided to the public most efficiently at a local level, and the small-scale productive sector activities that should be left to the private sector removed from local government function. The government may

wish to bolster the newly-established Public Corruption Unit with efforts to simplify administrative procedures, to strengthen financial management recording and reporting, and create a small office to examine citizen complaints about government inefficiency and corruption. Hainan should also resist temptations to create new offices and bureaus, choosing, rather, the reorientation of current offices and agencies towards regulatory functions in a market-oriented framework. More broadly, Hainan should review the size and function of its civil service to make it smaller, more efficient and more closely oriented to the public administration functions needed to support the market economy of the province.

6.18 As in other reforming socialist economies, institutions, professions and philosophies about economic behavior and regulation have to be created in Hainan. In assessing Hainan's ambitious menu of reforms intended to create market conditions, it must be remembered that legal and regulatory institutions in market economies have evolved over centuries. The secure legal environment, property rights and commercial relations, accounting, audit, and management systems, and human capital to upgrade technical and managerial practices do not materialize overnight. Accordingly, their current absence places some constraints on the speed of reform. The comprehensiveness of Hainan's reform efforts and proposals underlines the provincial authorities' wish to see in place a package of reforms without undue preoccupation with sequencing. However, creating a favorable environment for growth and investment, local as well as foreign, will require concerted action in three areas: the legal and administrative framework for trade and nonstate investment, the vision for public investment and the province's fiscal and banking system.

6.19 To realize its priorities as a model of comprehensive reform, Hainan will need to be able to use the powers envisaged in the State Council documents establishing the province, and see that its civil servants and those in Beijing operate according to those rules. If Hainan uses these powers effectively, it could in time become a market-oriented economy that other parts of China would want to emulate.

Distributors of World Bank Publications

ARGENTINA
Carlos Hirsch, SRL
Galeria Guemes
Florida 165, 4th Floor-Ofc. 453/465
1333 Buenos Aires

AUSTRALIA, PAPUA NEW GUINEA, FIJI, SOLOMON ISLANDS, VANUATU, AND WESTERN SAMOA
D.A. Books & Journals
648 Whitehorse Road
Mitcham 3132
Victoria

AUSTRIA
Gerold and Co.
Graben 31
A-1011 Wien

BANGLADESH
Micro Industries Development Assistance Society (MIDAS)
House 5, Road 16
Dhanmondi R/Area
Dhaka 1209

Branch offices:
156, Nur Ahmed Sarak
Chittagong 4000

76, K.D.A. Avenue
Kulna 9100

BELGIUM
Jean De Lannoy
Av. du Roi 202
1060 Brussels

CANADA
Le Diffuseur
C.P. 85, 1501B rue Ampère
Boucherville, Québec
J4B 5E6

CHINA
China Financial & Economic Publishing House
8, Da Fo Si Dong Jie
Beijing

COLOMBIA
Infoenlace Ltda.
Apartado Aereo 34270
Bogota D.E.

COTE D'IVOIRE
Centre d'Edition et de Diffusion Africaines (CEDA)
04 B.P. 541
Abidjan 04 Plateau

CYPRUS
Cyprus College Bookstore
6, Diogenes Street, Engomi
P.O. Box 2006
Nicosia

DENMARK
SamfundsLitteratur
Rosenoerns Allé 11
DK-1970 Frederiksberg C

DOMINICAN REPUBLIC
Editora Taller, C. por A.
Restauración e Isabel la Católica 309
Apartado de Correos 2190 Z-1
Santo Domingo

EGYPT, ARAB REPUBLIC OF
Al Ahram
Al Galaa Street
Cairo

The Middle East Observer
41, Sherif Street
Cairo

EL SALVADOR
Fusades
Alam Dr. Manuel Enrique Araujo #3530
Edificio SISA, 1er. Piso
San Salvador 011

FINLAND
Akateeminen Kirjakauppa
P.O. Box 128
SF-00101 Helsinki 10

FRANCE
World Bank Publications
66, avenue d'Iéna
75116 Paris

GERMANY
UNO-Verlag
Poppelsdorfer Allee 55
D-5300 Bonn 1

GUATEMALA
Librerias Piedra Santa
5a. Calle 7-55
Zona 1
Guatemala City

HONG KONG, MACAO
Asia 2000 Ltd.
46-48 Wyndham Street
Winning Centre
2nd Floor
Central Hong Kong

INDIA
Allied Publishers Private Ltd.
751 Mount Road
Madras - 600 002

Branch offices:
15 J.N. Heredia Marg
Ballard Estate
Bombay - 400 038

13/14 Asaf Ali Road
New Delhi - 110 002

17 Chittaranjan Avenue
Calcutta - 700 072

Jayadeva Hostel Building
5th Main Road Gandhinagar
Bangalore - 560 009

3-5-1129 Kachiguda Cross Road
Hyderabad - 500 027

Prarthana Flats, 2nd Floor
Near Thakore Baug, Navrangpura
Ahmedabad - 380 009

Patiala House
16-A Ashok Marg
Lucknow - 226 001

Central Bazaar Road
60 Bajaj Nagar
Nagpur 440010

INDONESIA
Pt. Indira Limited
Jl. Sam Ratulangi 37
P.O. Box 181
Jakarta Pusat

ISRAEL
Yozmot Literature Ltd.
P.O. Box 56055
Tel Aviv 61560
Israel

ITALY
Licosa Commissionaria Sansoni SPA
Via Duca Di Calabria, 1/1
Casella Postale 552
50125 Firenze

JAPAN
Eastern Book Service
Hongo 3-Chome, Bunkyo-ku 113
Tokyo

KENYA
Africa Book Service (E.A.) Ltd.
Quaran House, Mfangano Street
P.O. Box 45245
Nairobi

KOREA, REPUBLIC OF
Pan Korea Book Corporation
P.O. Box 101, Kwangwhamun
Seoul

MALAYSIA
University of Malaya Cooperative Bookshop, Limited
P.O. Box 1127, Jalan Pantai Baru
59700 Kuala Lumpur

MEXICO
INFOTEC
Apartado Postal 22-860
14060 Tlalpan, Mexico D.F.

NETHERLANDS
De Lindeboom/InOr-Publikaties
P.O. Box 202
7480 AE Haaksbergen

NEW ZEALAND
EBSCO NZ Ltd.
Private Mail Bag 99914
New Market
Auckland

NIGERIA
University Press Limited
Three Crowns Building Jericho
Private Mail Bag 5095
Ibadan

NORWAY
Narvesen Information Center
Book Department
P.O. Box 6125 Etterstad
N-0602 Oslo 6

PAKISTAN
Mirza Book Agency
65, Shahrah-e-Quaid-e-Azam
P.O. Box No. 729
Lahore 54000

PERU
Editorial Desarrollo SA
Apartado 3824
Lima 1

PHILIPPINES
International Book Center
Fifth Floor, Filipinas Life Building
Ayala Avenue, Makati
Metro Manila

POLAND
ORPAN
Palac Kultury i Nauki
00-901 Warzawa

PORTUGAL
Livraria Portugal
Rua Do Carmo 70-74
1200 Lisbon

SAUDI ARABIA, QATAR
Jarir Book Store
P.O. Box 3196
Riyadh 11471

SINGAPORE, TAIWAN, MYANMAR, BRUNEI
Information Publications Private, Ltd.
02-06 1st Fl., Pei-Fu Industrial Bldg.
24 New Industrial Road
Singapore 1953

SOUTH AFRICA, BOTSWANA
For single titles:
Oxford University Press Southern Africa
P.O. Box 1141
Cape Town 8000

For subscription orders:
International Subscription Service
P.O. Box 41095
Craighall
Johannesburg 2024

SPAIN
Mundi-Prensa Libros, S.A.
Castello 37
28001 Madrid

Librería Internacional AEDOS
Consell de Cent, 391
08009 Barcelona

SRI LANKA AND THE MALDIVES
Lake House Bookshop
P.O. Box 244
100, Sir Chittampalam A. Gardiner Mawatha
Colombo 2

SWEDEN
For single titles:
Fritzes Fackboksforetaget
Regeringsgatan 12, Box 16356
S-103 27 Stockholm

For subscription orders:
Wennergren-Willlams AB
Box 30004
S-104 25 Stockholm

SWITZERLAND
For single titles:
Librairie Payot
1, rue de Bourg
CH 1002 Lausanne

For subscription orders:
Librairie Payot
Service des Abonnements
Case postale 3312
CH 1002 Lausanne

TANZANIA
Oxford University Press
P.O. Box 5299
Maktaba Road
Dar es Salaam

THAILAND
Central Department Store
306 Silom Road
Bangkok

TRINIDAD & TOBAGO, ANTIGUA BARBUDA, BARBADOS, DOMINICA, GRENADA, GUYANA, JAMAICA, MONTSERRAT, ST. KITTS & NEVIS, ST. LUCIA, ST. VINCENT & GRENADINES
Systematics Studies Unit
#9 Watts Street
Curepe
Trinidad, West Indies

UNITED KINGDOM
Microinfo Ltd.
P.O. Box 3
Alton, Hampshire GU34 2PG
England

VENEZUELA
Libreria del Este
Aptdo. 60.337
Caracas 1060-A

Recent World Bank Discussion Papers *(continued)*

No. 138 *Coal Pricing in China: Issues and Reform Strategy*. Yves Albouy

No. 139 *Portfolio Performance of Selected Social Security Institutes in Latin America*. Carmelo Mesa-Lago

No. 140 *Social Security and Prospects for Equity in Latin America*. Carmelo Mesa-Lago

No. 141 *China's Foreign Trade and Comparative Advantage: Prospects, Problems, and Policy Implications*. Alexander J. Yeats

No. 142 *Restructuring Socialist Industry: Poland's Experience in 1990*. Homi J. Kharas

No. 143 *China: Industrial Policies for an Economy in Transition*. Inderjit Singh

No. 144 *Reforming Prices: The Experience of China, Hungary, and Poland*. Anand Rajaram

No. 145 *Developing Mongolia*. Shahid Yusuf and Shahid Javed Burki

No. 146 *Sino-Japanese Economic Relationships: Trade, Direct Investment, and Future Strategy*. Shuichi Ono

No. 147 *The Effects of Economic Policies on African Agriculture: From Past Harm to Future Hope*. William K. Jaeger

No. 148 *The Sectoral Foundations of China's Development*. Shahid Javed Burki and Shahid Yusuf, editors

No. 149 *The Consulting Profession in Developing Countries: A Strategy for Development*. Syed S. Kirmani and Warren C. Baum

No. 150 *Successful Rural Finance Institutions*. Jacob Yaron

No. 151 *Transport Development in Southern China*. Clell G. Harral, editor, and Peter Cook and Edward Holland, principal contributors

No. 152 *The Urban Environment and Population Relocation*. Michael M. Cernea

No. 153 *Funding Mechanisms for Higher Education: Financing for Stability, Efficiency, and Responsiveness*. Douglas Albrecht and Adrian Ziderman

No. 154 *Earnings, Occupational Choice, and Mobility in Segmented Labor Markets of India*. Shahidur R. Khandker

No. 155 *Managing External Debt in Developing Countries: Proceedings of a Joint Seminar, Jeddah, May 1990*. Thomas M. Klein, editor

No. 156 *Developing Agricultural Extension for Women Farmers*. Katrine A. Saito and Daphne Spurling

No. 157 *Awakening the Market: Viet Nam's Economic Transition*. D. M. Leipziger

No. 158 *Wage Policy during the Transition to a Market Economy: Poland 1990–91*. Fabrizio Coricelli and Ana Revenga, editors

No. 159 *International Trade and the Environment*. Patrick Low, editor

No. 160 *International Migration and International Trade*. Sharon Stanton Russell and Michael S. Teitelbaum

No. 161 *Civil Service Reform and the World Bank*. Barbara Nunberg and John Nellis

No. 162 *Rural Enterprise Development in China, 1986–90*. Anthony J. Ody

No. 163 *The Balance between Public and Private Sector Activities in the Delivery of Livestock Services*. Dina L. Umali, Gershon Feder, and Cornelis de Haan

No. 165 *Fisheries Development, Fisheries Management, and Externalities*. Richard S. Johnston

No. 166 *The Building Blocks of Participation: Testing Bottom-up Planning*. Michael M. Cernea

No. 167 *Seed System Development: The Appropriate Roles of the Private and Public Sectors*. Steven Jaffee and Jitendra Srivastava

No. 168 *Environmental Management and Urban Vulnerability*. Alcira Kreimer and Mohan Munasinghe, editors

No. 169 *Common Property Resources: A Missing Dimension of Development Strategies*. N. S. Jodha

The World Bank

Headquarters
1818 H Street, N.W.
Washington, D.C. 20433, U.S.A.

Telephone: (202) 477-1234
Facsimile: (202) 477-6391
Telex: WUI 64145 WORLDBANK
RCA 248423 WORLDBK
Cable Address: INTBAFRAD
WASHINGTONDC

European Office
66, avenue d'Iéna
75116 Paris, France

Telephone: (1) 40.69.30.00
Facsimile: (1) 40.69.30.66
Telex: 640651

Tokyo Office
Kokusai Building
1-1 Marunouchi 3-chome
Chiyoda-ku, Tokyo 100, Japan

Telephone: (3) 3214-5001
Facsimile: (3) 3214-3657
Telex: 26838

ISBN 0-8213-2169-2

Paper Number 170

A Chinese Province as a Reform Experiment: The Case of Hainan

The World Bank