



“Better Policies” Series

# CHINA

## STRUCTURAL REFORMS FOR INCLUSIVE GROWTH

MARCH 2014



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## FOREWORD

In spite of a slow and uneven global recovery over the past five years, China has maintained strong growth and continued to tackle income inequality, which had been rising, as well as poverty. Growth has become more inclusive thanks to ambitious policy initiatives, such as the extension of the coverage of public health care and pension systems, as well as the minimum subsistence allowance for the rural population.

Despite tremendous improvements in living standards, major challenges remain. The plight of migrants, while improving, still deserves attention. The quality of health care and education in rural areas is far below that in coastal cities. And, in some places, environmental degradation and pollution seriously threaten the well-being of the population.

In this context, the comprehensive reform roadmap set out at the Third Plenum of the Eighteenth Chinese Communist Party Central Committee should help bring about the “Chinese Dream” centred on national development, individual prosperity, good governance and sustainable, green growth. The specific measures that were recently announced at the National People’s Congress chime with many of the recommendations featuring in this report.

Drawing on the expertise and collective experience of OECD member and partner countries, this Report presents recent OECD analysis and policy advice in areas that are critical to China’s long-term economic performance and social development. They encompass inclusive growth, financial system reform, fiscal policies, trade and investment, agriculture, green urbanisation and energy.

Going forward, one of China’s greatest challenges will be to share the gains of prosperity more broadly. Among other policy recommendations, the Report proposes several initiatives to further strengthen the country’s economic performance in support of inclusive growth, not least through further improvements to education and skills. As the population ages, this task will become harder. Hence, policy efforts are needed to expand the three main pillars of effective social protection (health care, pensions and unemployment), particularly among migrants and the rural population.

The Report also discusses options for continuing along the path of trade and foreign investment liberalisation, as well as strengthening of farmers’ land rights, to improve the prospects of the consolidation of farm land and the resulting productivity gains. Urban, energy and transport policies need to be greened, ensuring that price signals reflect the cost of pollution, raising environmental standards and improving their enforcement.

The OECD takes pride in its cooperation and policy dialogue with China and looks forward to contributing to China’s stronger, cleaner and fairer economic growth. China’s participation in the work of OECD committees and bodies enriches the policy discussions and outcomes. Today, this partnership is more relevant than ever, as China consolidates its role as a powerful and constructive player in the world’s trade, economic and financial governance.



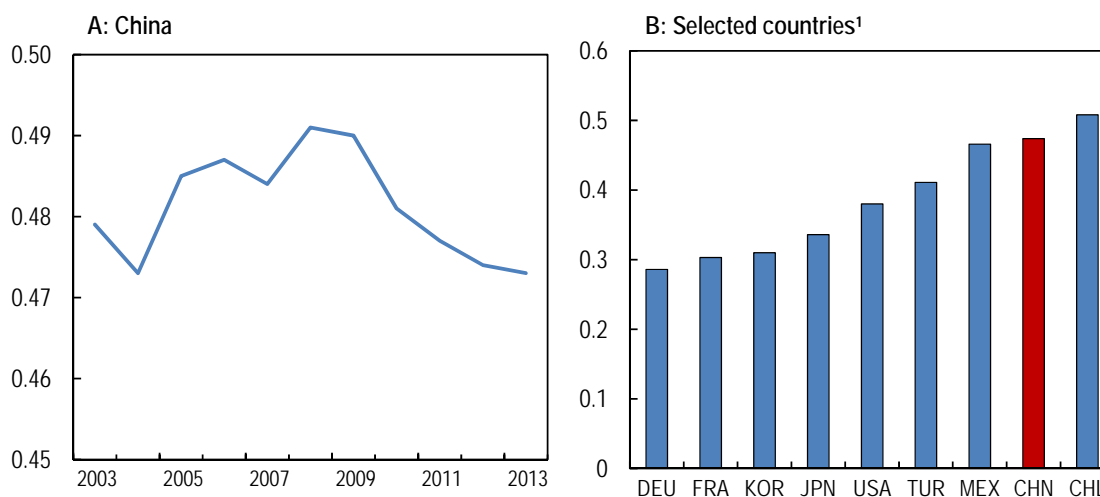
Angel Gurría  
Secretary-General, OECD

# 1. TOWARDS MORE INCLUSIVE GROWTH

## Challenges

In the five years to 2013, real national income rose at an annual average rate of 8.6%, while the share of household income in total national income has stabilised. In the process, the benefits of growth have accrued to a wider section of society. Both in rural and urban areas, the income of the lowest decile of households rose faster than that of the top decile. The number of people living in absolute poverty fell from 99 million in 2012 to 82.5 million in 2013 (6% of the population) on the national definition of an income above \$1.50 per day in PPP terms. Most rural poverty is now concentrated in areas with harsh and inhospitable natural conditions. Although these recent developments have unwound most of the increase in inequality that occurred between 2003 and 2008, the Gini coefficient remains high, at 0.47 (Figure 1). This slightly exceeds the 0.45 weighted average for the three OECD countries with the lowest income per head and highest levels of inequality (Chile, Mexico and Turkey), though on some measures inequality is higher still in several other large emerging market economies.

**Figure 1. Growth has become more inclusive in recent years**  
Nationwide Gini coefficient based on disposable income



1. Data for 2010 except for Japan (2009).

*Note:* The Gini coefficient is a measure of income inequality that ranges from 0 (all individuals have the same income, or complete equality) to 1 (one individual has all the income).

*Source:* OECD and National Bureau of Statistics.

The improvement in income distribution in the past five years largely reflects two factors: the continued shift from jobs in farming to better-paid non-agricultural jobs associated with urbanisation, as well as government social policies extending social safety nets. These have generalised pensions for rural elderly people and lowered health care co-payments from individuals substantially, boosting social transfers by an estimated five percentage points of household disposable income.



A key challenge facing the government going forward is to facilitate and make the most of rural-to-urban migration, especially in a context of rapid demographic ageing. For this, the government needs to improve the environment for business so that companies can generate sustained productivity growth, ensuring a continued steady increase in economic activity and living standards. Reforms to remove impediments to competition and allow market forces to play a more prominent role are needed in various areas. Administrative controls, such as price regulation and the approval needed for investment projects, hold back economic expansion. Regulated interest rates cause companies to use capital inefficiently. A gradual liberalisation of financial markets could improve the allocation of credit, but it requires careful sequencing and a strong prudential regulatory framework (Chapter 9). A further challenge for the government is to ensure that barriers to entry for non-public companies in parts of the service and manufacturing sectors are removed. On all these fronts, the implementation of the decisions of the latest Party Plenum and National People's Congress will be key.

To ensure the inclusiveness of structural economic reforms, the discrimination faced by migrants needs to be reduced. Migrants should be allowed to keep their land-use rights and their right to have more than one child, which is more extensive than for urban dwellers even after the recent liberalisation. Adequate additional land for urban expansion is needed in those areas with the highest productivity and attractiveness to avoid incomes accruing too exclusively to existing property owners. Social protection needs to be provided to all urban residents in a non-discriminatory fashion. Reform efforts also need to be directed at improving the quality and efficiency of the health care system (Chapter 4) and at furthering the consolidation and sustainability of the pension system (Chapter 3). In education, another key pillar of inclusive growth, China needs to reduce inequalities in access to quality schooling, particularly for disadvantaged students and children of migrant families (Chapter 5). A number of important reforms are in train in all these areas but country-wide follow-through is often a major challenge.

### **Main policy recommendations**

- All service sectors and energy distribution should be opened more to competition.
- Government approvals for business sector investment should be eased, while maintaining clearance for compliance with environmental, safety and zoning restrictions.
- Restrictions on inward foreign direct investment should be eased further.
- Remaining energy price controls should be lifted.
- All citizens should be eligible for public services on an equal footing, including access to education all the way to and including tertiary education and quality health care.
- The vesting period for social security pensions should be reduced to allow better pensions for migrant workers. The retirement age for men and women should be raised gradually to 65 and thereafter linked to life expectancy.
- The new national social security card should form the basis for a national employee pension system.

### **OECD Work**

The OECD is developing a new policy framework for inclusive growth that combines strong economic growth with improvements in living standards and outcomes that matter for people's quality of life (e.g. good health, jobs and skills, clean environment, community support). The report *Divided We Stand* analyses the growing income inequality, while *How's Life* looks at people's material living conditions and quality of life across the population. The *Better Life Index* is an on-line tool that allows citizens to compare well-being across 34 countries, based on 11 dimensions the OECD has identified as essential, in the areas of material living conditions and quality of life: housing, income, jobs, community, education, environment, governance, health, life satisfaction, safety, work-life balance.

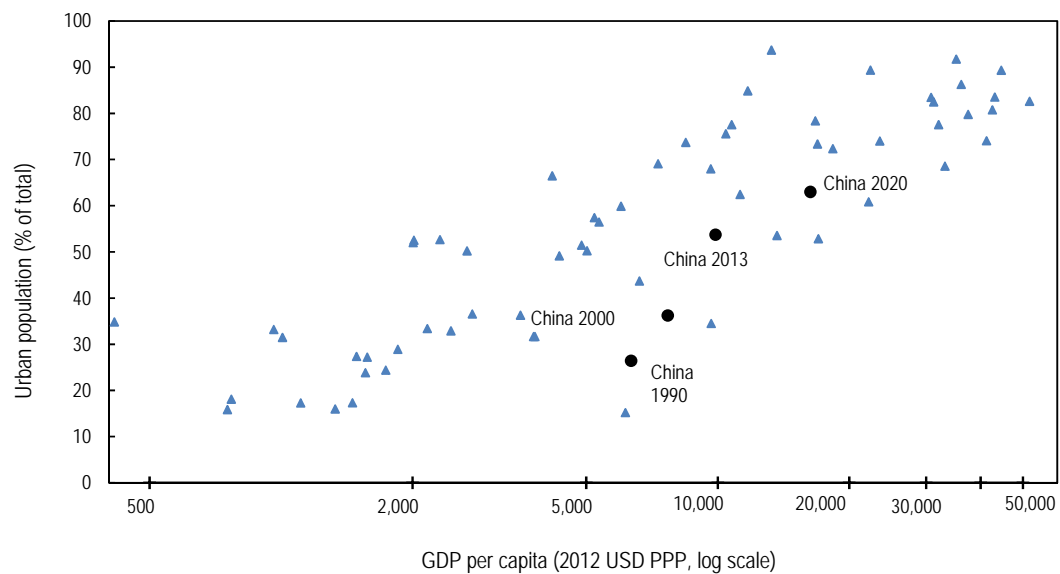
## 2. CHINA'S NEW-STYLE URBANISATION: SMARTER, GREENER AND MORE INCLUSIVE

### Challenges

Urbanisation is a powerful enabler of growth and social change and is proceeding at very rapid pace. China's urban population rose by over 100 million in the five years to 2013, reaching over 730 million. Indeed, last year the urbanisation rate was over two percentage points above the rate expected for 2015 in the current Five Year Plan, making China much less of an outlier, given its income level, than in the past (Figure 2). As people have moved away from the countryside, living standards have improved rapidly. While urbanisation brings considerable benefits, it also presents big challenges, including pressures on land use, the environment and the urban infrastructure, as well as the need to ensure a fair treatment of all people living in cities.

**Figure 2. Urbanisation has been progressing rapidly in China**

The level of urbanisation in every country or territory with a population over 15 million



Data refers to 2012 except for China.

*Source:* World Bank, World Development Indicators; National Bureau of Statistics; National Population and Family Planning Commission (2011); OECD Economic Outlook 93 long-term database; and OECD calculations.

People have chosen to move to the largest cities, where productivity and wages are highest. However, as the supply of new building land has been restricted in mega-cities, this influx of population has resulted in housing prices rising much more rapidly in these areas than in the rest of China. A sizeable share of the benefits has accrued to existing land-use right owners or local governments as the ultimate owners of urban land, making urbanisation less inclusive. Many migrants and town dwellers have been housed on properties built on rural construction land in villages that are located inside cities but whose ownership cannot legally be transferred to urban residents.



The government has started to ensure that local authorities provide some social benefits to migrants, whose total number amounted to 289 million in 2013. Local authorities where children of migrants live are now responsible for educating children up to the age of 15, though often the quality of the schools offered to migrant children is low. Access to upper-secondary schools, local health care, minimum subsistence payments and pension remains limited, however. The recent announcements of the Third Plenum of the CPC in November 2013 to further reform the *hukou* system is a move in the right direction. The best way forward would be to further delink the eligibility for urban public services from *hukou* status.

In most Chinese cities, air pollution is severe, with concentrations of pollutants such as SO<sub>2</sub>, NO, and PM<sub>2.5</sub> several times in excess of WHO standards. This results in a higher incidence of respiratory disease in urban populations, particularly among infants and other vulnerable groups. Moreover, emissions are transported across borders, raising pollution levels in other countries. According to the OECD, from 2005 to 2010, China experienced a 90% increase in the economic cost of deaths from ambient air pollution, estimated at around USD 1.5 trillion for 2010. The supply of water also poses a problem in cities in northern China.

The development of public transport infrastructure has been impressive but remains below the level in many advanced countries. Better urban planning can ensure that development is linked to urban transit networks and facilitates access to local services and jobs, so helping to reduce automobile congestion particularly in conjunction with congestion charges. Better policy packages can help ensure that more efficient use of land further enhances the overall quality of life. Such packages are too complex and inter-related for a single level of government to address effectively, calling for collaboration across levels of government.

### Main policy recommendations

- **Introduce zoning and planning requirements**, ease restrictions on the use of agricultural land for development and housing, and allow farmers to sell land to developers directly subject to special taxation of gains.
- **Disconnect access to local public services from local registration**, particularly in relation to access to local high schools and universities.
- Implement measures to **reduce pollution from motor vehicle use**, including taxing transport fuels, improving fuel quality, limiting diesel use, linking taxation of vehicles to their environmental performance, and implementing congestion charges (rather than license plate rationing).
- **Improve pricing of energy, water and other natural resources** so as to gain in resource efficiency and reduce pollution. Market-based measures need to be complemented by strong environmental standards and sound urban planning.
- **Improve water management** through effective water allocation regimes and management arrangements and increase water-use efficiency. Raise the proportion of people connected to water supply and sanitation.

### OECD work

The OECD's *Water Security for Better Lives* could help China improve water management to tackle water security in a cost-effective manner by using a risk-based approach. Guidelines for policymakers feature in *Water and Climate Change Adaptation: Policies to Navigate Uncharted Water*. China was invited to participate in discussions to prepare *OECD Principles for Effective Public Investment across Levels of Government*, which will be submitted for approval as an OECD instrument in March 2014.

### 3. FURTHER CONSOLIDATING THE SOCIAL SAFETY NET

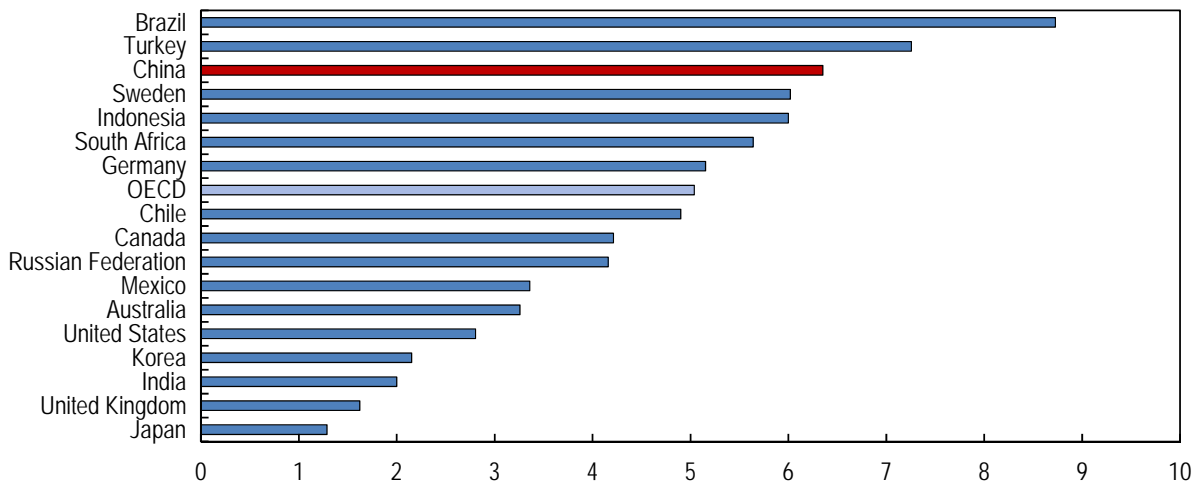
#### Challenges

Public social spending has risen rapidly in China since 2006. By 2012, it stood at 9% of GDP, exceeding the levels in some other emerging economies (e.g. Mexico or India), but standing below the OECD average (22%). The bulk of the increase in expenditure has gone towards extending the coverage of different forms of social protection, in particular contributory social schemes. The public health system is now effectively universal (see chapter 4), while the public pension system covers almost 85% of the population that is not in full-time education.

Notable reforms include the extension of the minimum subsistence allowance to the countryside, the introduction of new medical insurance schemes for people with rural registration status, dependants of registered urban employees and students, and the introduction of a new pension system for people living in the countryside and another for migrant workers. Under the aegis of the 12<sup>th</sup> Five Year Plan, public social expenditure is projected to further increase and rise faster than GDP in the coming years. Measures combining social insurance and assistance schemes are expected to contribute to establishing a social security system covering all residents in urban and rural areas by 2020.

Despite much progress, many challenges remain. The average level of benefits under many of the rural social protection schemes is low. Following the new Social Security Law, more firms in urban areas are complying with the new laws, as penalties have been placed on a firmer legal basis. Furthermore, the system of compensation for loss of employment rests largely on severance payments set by the new Labour Law. For those workers with indefinite duration labour contracts and significant seniority, the total value of unemployment compensation based on public unemployment insurance benefits and mandatory severance payments are quite high relative to other countries (Figure 3).

**Figure 3. Maximum value of unemployment benefits and severance payments for a laid-off person with four years of seniority, if unemployed for one year**



Source: OECD Employment Outlook 2011.

On the other hand, there is a low coverage of unemployment benefits, as even amongst the registered unemployed (mostly people with a local non-agricultural *hukou*), only a small proportion receives benefits. Amongst the 43% of migrant workers that have labour contracts, most do not qualify for compensation as they have short duration contracts. In 2012, only 8% of migrant workers were affiliated to the unemployment insurance system. All of these factors result in the proportion of the unemployed who received benefits in 2012 being under 10%, compared to 30% in Brazil and 25% in Russia (2007/8 figures).

Despite many reform initiatives in recent years, China's pension system remains segmented, with different regimes for the rural, urban and public sectors, as well as within each of them. The schemes for rural and certain urban employees are being merged and the financing is being transferred largely to the central government. The low official retirement age (currently 60 for men, 55 for white-collar women and 50 for blue-collar women) is also a major challenge for retirement income provision in a rapidly ageing society. The normal pension age for both men and women should be gradually raised to 65. Other measures would be necessary to complement the increase in the retirement age, such as providing training for older workers and banning old-age discrimination in the workforce. A third challenge concerning pensions pertains to the modest level of benefits for the rural population, despite recent increases.

### Main policy recommendations

- **Improve the coverage and targeting of unemployment insurance:** shift the focus from job security (strict labour protection) to policies oriented towards facilitating the job search and improving the employability of workers. This will also help to make unemployment compensation more redistributive.
- **Lift the retirement age;** align the age for men and women and then link it to life expectancy.
- **Gradually consolidate the various pension regimes.** The pension system for urban employees should become a national scheme, so that benefits can be carried from one city to another.

### OECD work

The OECD work on *social policies* aims at improving social welfare in a context of population ageing, globalisation and rapid technological change. Its activities are focused on:

Modernising social protection systems to extend opportunities for all and respond to demographic challenges; this includes notably pension systems, disability and family benefits as well as long-term care.

Designing employment-oriented social policies to promote the participation in the labour market of under-represented groups while combating poverty and social exclusion; this includes notably unemployment and social assistance, in-work benefits and housing benefits.

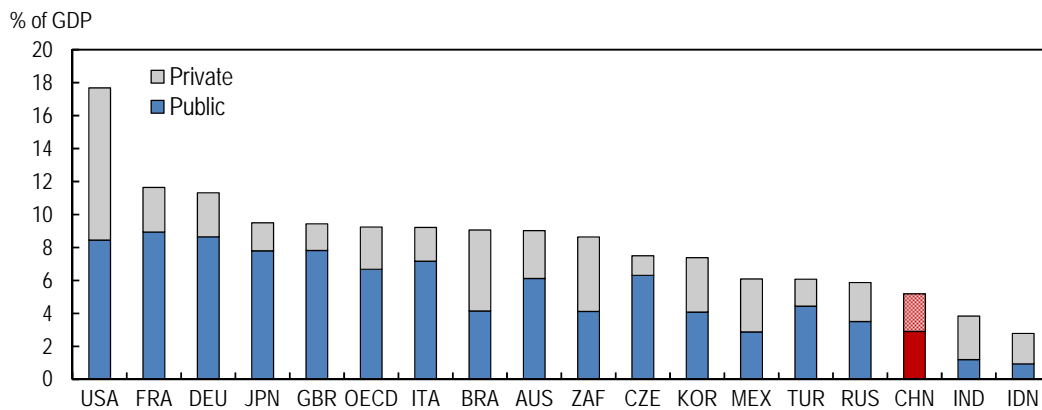
The impact of population ageing on the labour market and social safety nets, the performance of long-term care systems, the financing of social protection systems, and the implications of migration flows are other major themes of the OECD's work in this area.

## 4. ADVANCING HEALTH CARE REFORM

### Challenges

By 2012, public medical insurance coverage was nearly universal. Concomitantly, the share of out-of-pocket expenses declined from 60 to 34%. In the process, government outlays rose to 56% of total health expenditure against 72% on average in the OECD area in 2011. Total health care spending rose to 5.4% of GDP in 2012, or USD 487 per capita at PPP exchange rates, in line with other countries at similar income levels, though well below the 2011 OECD average of 9.2% of GDP or USD 3 322 per capita (Figure 4). Despite almost universal coverage of previously uninsured groups (people living in the countryside and economically inactive people in urban areas), benefits are low. However, in 2013, the government raised its expenditure on health care by over 25%, which may have pushed up health care spending to around 5.8% of GDP. The government intends to raise health expenditure by 15% in 2014 and to reduce out-of-pocket health expenditure to 30% of total outlays by 2015.

Figure 4. Total health expenditure in 2011



1. Data for 2011 except for Australia, Japan and Mexico (2010), and Turkey (2008).

Source: OECD, Health at a Glance, Asia-Pacific, 2012; OECD, OECD Health Data: How does China Compare with OECD Countries?, 2013

Like many OECD countries and emerging economies, China must address the rise of non-communicable, chronic diseases (e.g., cancer, cardiovascular diseases, diabetes, asthma, etc.). Major risk factors include smoking (Chinese men have one of the highest smoking rates in the world), alcohol consumption, physical inactivity and unhealthy diets and obesity (the rate of which tripled in China in the last 15 years). China's non-communicable disease burden is higher than other emerging economies and outcomes are worse. There are important implications for the health system in tackling chronic diseases. The current system is tilted towards the provision of complex hospital care. Therefore, chronic diseases are addressed very late in their course. In addition, while the number of doctors has risen fast, incumbent doctors are often insufficiently qualified. Attracting skilled doctors to work in primary care is difficult due to low salaries and poor career prospects.

Furthermore, while the growth of health insurance has been remarkable, there are still challenges. The fragmentation of insurance schemes combined with the *hukou* system has particularly affected the coverage of migrant workers. They typically pay higher out-of-pocket expenses and have to claim reimbursement of fees in their home county with much lower reimbursement rates and long lags.

There are also considerable challenges in the organisation and financing of the hospital sector. The current fee-for-service system distorts the provision of services towards needlessly costly procedures and fuels inefficiencies in the hospital system. The government has attempted to deal with the problem by restricting the mark-up of pharmaceuticals, but to date this is mainly applied at the primary care level and only in a few hospitals. Furthermore, this approach does not address the underlying problem, which is that government is providing inadequate financing to fund the operating costs of hospitals, meaning they are then required to make up the difference by charging patients.

Rationalising the use of pharmaceuticals is a further challenge. Hospitals rely on the profit from drug sales to balance their books. Official data is not available, but taking into account medicines sold outside hospitals, pharmaceutical spending accounted for 1.7% of GDP, a similar proportion to that in the OECD area. Pharmaceutical consumption is expected to increase, driven by the shift in morbidity and population ageing, among other factors. China's National Essential Drug Programme aims to tackle this issue by making access to inexpensive quality medicines a priority. However, since the profit margin on these selected drugs is low, hospitals avoid using them, preferring more profitable drugs with similar health gains. A new framework for centralised procurement at provincial level should help lower prices and improve the availability of drugs, including generics, by promoting competition and price transparency. The adoption of a sound system to ensure efficient use of pharmaceutical spending is a priority but this is going to require reform of hospital finances and of the pay system for doctors.

### Main policy recommendations

- Enhance public education and awareness and other means of prevention and early diagnosis to **reduce the incidence of chronic diseases**. The cost of a comprehensive prevention strategy for China would be only around USD 2 per year per person; an investment lower than for other large middle-income economies.
- Regularly **monitor the quality** and cost of health care provided, by systematically collecting health care and hospital performance indicators.
- **Harmonise benefits** across different health insurance schemes while promoting administrative efficiency, including by expanding the use of electronic health records. Improve migrants' healthcare coverage, independently from their registered residency status (*hukou*). Ensure that a greater proportion of health insurance schemes' funding is shouldered by the central government.
- **Reform the hospital sector**: Fees should be matched more closely to the cost of production. Public hospitals should be given greater latitude to manage their personnel, in order to better adapt to changing circumstances. A more enterprise-oriented management and accounting system would ensure higher quality of service, relying on appropriate use of relevant performance indicators.
- Ensure **adequate training and pay** to encourage doctors and other health workers to choose career paths that match social needs.
- Further promote an **efficient use of pharmaceuticals** by improving access to affordable and effective medicines and promoting centralised procurement procedures.

## **OECD work**

The OECD helps countries to increase the efficiency of their health systems by applying economic analysis to health policies. The mission of the OECD in health – advising policy makers and informing public and private stakeholders and citizens on how to address demands for more and better quality health care – is particularly important with public budgets under strain. The OECD produces reliable statistics of health system performance and helps countries benchmark their policies against high-performing health systems. We identify good practices across our member and partner countries on issues such as: strengthening primary care and the prevention of illness; improving the efficiency of hospital services; paying doctors and hospitals in ways that assure high-quality care; adapting health care to address the complex needs of the frail elderly; and, assuring optimal care for chronic diseases, particularly cancer and cardio-vascular diseases. By sharing knowledge and expertise on best practices in these areas and by encouraging countries to learn from their peers, the OECD helps design better health policies for better lives.



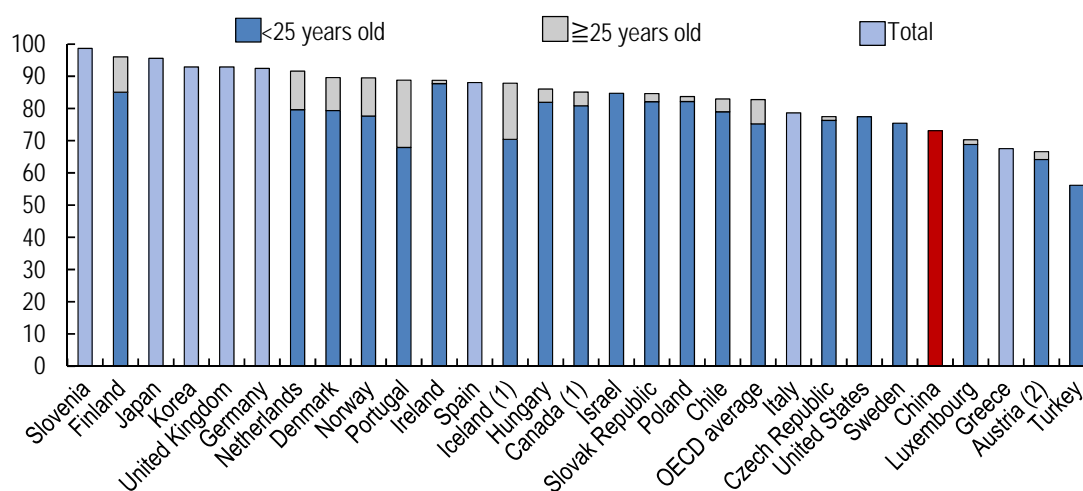
## 5. EXTENDING HIGH-QUALITY EDUCATION

### Challenges

China has made remarkable progress in raising access, quality and equity in education. The generalisation of free nine-year compulsory schooling has been a great achievement. Since 2009, net enrolment in primary schooling has exceeded 99%, and gross enrolment at senior secondary level, both general and vocational, has reached 79%. The general senior secondary schools enrol 52.5% of students at this level, putting about half of senior high school students in the academic stream. Shanghai now leads the world in student performance as measured by the OECD's Programme for International Student Assessment (PISA) and demonstrates that high quality can be achieved alongside high equity, with many students from disadvantaged backgrounds outperforming their peers in every OECD country by a large margin.

Beyond these successful experiences, however, there is a need to provide better schooling in smaller cities and rural areas, and to provide disadvantaged students with more financial and pedagogical support. Migrant children also find it almost impossible to enter academic senior high schools in the area where they live and lower-level schools catering to these students often have lower budgets than other schools. There is also a need for greater school autonomy, as well as more advanced pedagogical methods to upgrade the qualification of teachers and to instil more creativity and adaptability in students. Current graduation rates also conceal significant regional disparities, and China faces daunting challenges to provide high-quality education and training for its large rural population. The figures for the younger generation also conceal that much of the older generations had no access to education. As a result, in 2011 only 22% of the adult population in China had completed upper-secondary school. Based on current patterns, it is estimated that an average of 73% of Chinese young people will complete upper-secondary education over their lifetimes, compared to 83% on average in the OECD (Figure 5).

**Figure 5. Upper secondary graduation rates (2011)**



Notes : 1. Year of reference 2010. Countries are ranked in descending order of the upper secondary graduation rates in 2011. Only first-time graduates in upper secondary programmes are reported in this chart.

2. Programmes spanning ISCED levels 3 and 4 (Higher Vocation schools / Höhere berufsbildende Schule) are not included.

Source: OECD, Education at a Glance, 2013

As well as the improvement seen at the school level, starting in 1998, China broke away from its long-standing policy of restricting higher education to a small percentage of the population and launched a spectacular expansion. The number of graduates from three- and four-year higher education increased six fold between 2000 and 2012. In 2013, with the number of college-age young people falling, the graduation rate from higher education rose to 32%, while the enrolment rate was even higher.

Despite this progress, significant mismatch between the skills of Chinese graduates and those demanded by the economy have led to growing difficulties in joining the labour market and rising levels of graduate unemployment. This signals the need to improve the relevance of education. Strengthening skills will be vital for China's long-term growth, employment and competitive edge. Similarly, effective skills policies will be an indispensable part of addressing inequality.

### Main policy recommendations

- Provide disadvantaged students with **more financial and pedagogical support**, improve the quality of schooling in smaller cities and rural areas and end discrimination against migrant children in urban areas.
- Ensure an **effective implementation of the curriculum reform** by better aligning the university entrance exam with the objectives of the curriculum reform, as it is still heavily focused on the reproduction of subject matter content and by upgrading teacher education.
- Develop a solid understanding of those skills that drive strong and sustainable economic and social outcomes to **ensure that the right mix of skills is being taught** and learnt in effective, equitable and efficient ways.
- Put in place **strong effective governance arrangements** to generate sustainable approaches to educational finance.
- Establish a system of **quality standards and indicators** to drive the modernisation of China's education system. This will allow comparisons of China's education system both internationally and between provinces, so that they can identify their strengths and weaknesses.

### OECD work

China will participate in **PISA 2015** at the national level and was well represented at the meeting of the PISA Governing Board in November. This follows the successful completion of trial tests organised by the Chinese government in nine provinces. The OECD has offered China support in enhancing the usefulness of PISA for reforms of China's examination and university entrance systems.

China is considering participation in other surveys, such as the Teaching and Learning International Survey (TALIS) and OECD Survey on Adult Skills (PIAAC). In the past five years, the OECD conducted two reviews of the Chinese education system, on Tertiary Education (2009) and on Learning for Jobs (2010).

## 6. AGRICULTURAL MODERNISATION AND FOOD SECURITY

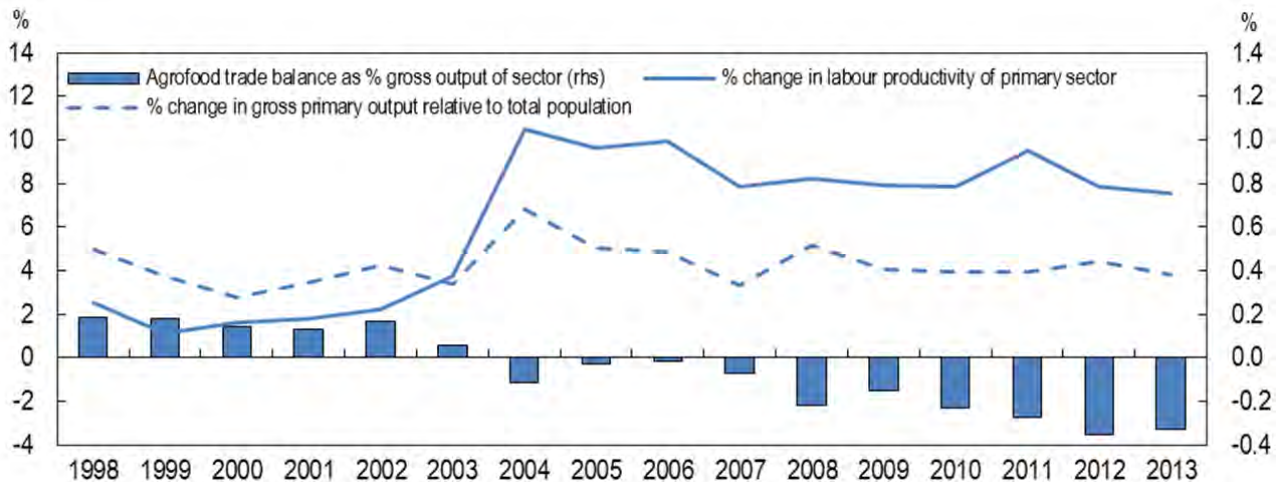
### Challenges

China's progress in improving food availability has been impressive. The number of undernourished people fell from 272 million in 1990-92 to 158 million in 2011-13 – 66% of the worldwide drop; and the incidence almost halved, falling to 11.4% of the population. Progress has been achieved by a doubling of food production per person and an increase in protein supply per person of more than one-third in the two decades through to 2010. Currently, undernourishment in China is concentrated among the poorest in rural areas, often amongst members of households in small-scale farms.

China's agriculture is dominated by small-scale farming, very intensive in terms of input use – fertilizers and pesticides – leading to high land productivity. With continued rural-urban migration, the number of farmers is falling, and, at the same time, the population of farmers is ageing rapidly. Consolidation of smaller farms and further mechanisation will be needed to ensure increases in production from a smaller agricultural labour force.

With higher incomes, diets will continue to improve, and demand for water-intensive food, such as meat and dairy products, will require policies to better manage the growth of water demand, particularly in Northern provinces. Moreover, rapid development has generated severe environmental pollution. OECD estimates show that China's agricultural policies have entailed growing costs for consumers and taxpayers: the total cost of support provided to China's agriculture (including support to producers, subsidies to consumers and the cost of specific public services provided to agriculture) stood at 2.3% of GDP in 2010-12, far above the OECD average of 0.9%.

**Figure 6. Food production per capita and agricultural productivity are rising rapidly, but the agro-food trade balance is now in deficit**



Source: Comtrade, CEIC, China Statistical Yearbook, National Bureau of Statistics.

At the national level, food consumption has been rising faster than production, so China has become a net importer of food (Figure 6). Most of the increase in demand for food results from increased meat consumption, which boosts the use of cereals for animal feed. Human consumption of cereals in contrast has been growing only modestly. With a growing need for land to expand cities and for feed, China will become more dependent on imports, reflecting a lack of comparative advantage, in particular for land-intensive crops. In these circumstances, the sources of food imports need to be diversified to maintain food security.

### Main policy recommendations

- **Improve access of the rural poor to education and health care**, and improve the rural infrastructure. For the elderly, the government should - as envisaged - quickly take full responsibility for rural pensions and also gradually increase their level.
- Gradually **replace input subsidies by direct payments** paid at a flat rate per unit of land, with no requirement to purchase a given input or to produce a specific commodity.
- Improve agricultural productivity via **enhanced innovation**: further strengthen research and development, technology adoption and transfer, education, and farm training and advisory services; consider new seeds (including GMOs) and applying better fertilisers.
- Enhance efficient water use by **adjusting water pricing** to cover water provision costs and to stimulate a move away from water-intensive crops.
- Diversify sources of food through **stronger integration of domestic and international agro-food markets**: taking into account China's ample monetary reserves and continued current account surpluses which enable it to buy food on international markets, maize should be eliminated from the 95% self-sufficiency objective; stronger integration with international markets should also be pursued to reduce the volatility of food supplies on domestic markets.
- Enhance the development of the land market: **strengthen the land rights of farmers**, allowing them to buy, sell, lease and inherit land rights, so as to improve prospects for larger farms and mechanisation; when agricultural land is converted to other uses base the compensation paid on market prices less a significant tax; allow farmers to sell land zoned as residential directly to developers.

### OECD work

The OECD works on both the supply and the demand side dimensions of food security, focusing on how government policies can influence the availability of food sustainably, and on ways in which governments can improve citizens' access to food. The OECD also collaborates with the Food and Agriculture Organisation (FAO) on food security, including via the joint annual *Agricultural Outlook*, a prominent and authoritative source of market information, analysis and projections.

## 7. REFORMING THE ENERGY MARKET TO PROMOTE GREEN GROWTH

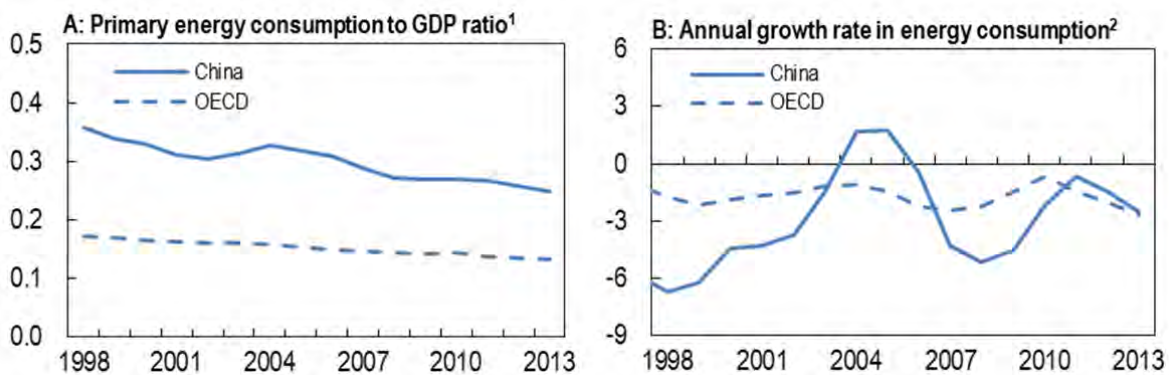
### Challenges

China's Five Year Plans have been increasingly emphasizing the need for greener and more sustainable growth. In recent years, China has improved energy efficiency faster than the OECD area, though energy consumption per unit of GDP remains much higher in China (Figure 7). OECD analysis shows that carbon pricing and fossil fuel subsidy reforms are fundamental for sending clear signals to investors and users. China's recent launch of pilot carbon emission trading programmes is a step towards achieving the international goal of limiting the global average temperature increase to 2°C above pre-industrial levels and should also help reduce local pollution pressures.

Building a business case for investment in new green technologies and infrastructure requires targeted policies. The OECD has developed a five-point Green Investment Policy Framework to improve the risk-return equation for the private sector and draw capital market investment into green projects. The shift toward green investments may require additional spending in the short term, but could also deliver net savings in the long run thanks to system-wide efficiency gains. The policy framework is being tested in the building sector in Germany, in bus rapid transit systems in Mexico, in renewable energy in South Africa, and in energy efficiency in buildings in France.

In order to diversify its coal-based energy mix, China has introduced significant economic incentives for renewable technologies since 2005 – including through feed-in tariffs, quotas for electric utilities, biomass power development programmes and solar photovoltaic support policies. Nonetheless, the most cost-effective method to reduce carbon emissions would be through carbon pricing rather than via sectoral or technology-based subsidies. An effective way to control carbon emissions, and so control the use of coal, as advocated in the 60 decisions of the Third Plenum of the CCP reform plan, would be to introduce a carbon tax.

**Figure 7. China's economy is gradually becoming more energy efficient<sup>1</sup>**



1. Primary energy consumption per thousand \$PPP GDP in constant 2005 prices. Figures for 2013 are estimates. China includes Hong Kong, China.

2. Three-year moving averages.

Source: International Energy Agency, World Energy Balances.

While Chinese investment in wind and solar energy fell by 4% in 2013 to USD 61 billion, installed capacity rose significantly as solar panel prices fell. Against this already high level of spending, government estimates point to the need for spending to rise by a further USD 40 billion per year to reach the targets of the 12<sup>th</sup> Plan for installed capacity of carbon-free energy. Recent estimates<sup>1</sup> suggest that a further annual expenditure of USD 200 billion are needed to support **mitigation efforts and reach the government's target to reduce emission intensities in 2020 by 40-45% from their level in 2005.**

In the OECD area, many governments have decided, given the fall in the price of photovoltaic cells and the high cost of saving carbon through solar energy, that reductions in feed-in tariffs for solar energy were needed. China may need to review its feed-in tariffs in the future, especially if transmission costs for solar energy produced in the west of the country prove to be high. Coherent implementation is thus central to addressing solvency and economic efficiency of the energy sector transformation, with due regard to the cost of carbon saving in each area.

### **Main policy recommendations**

- Strengthen price signals that reflect the social cost of pollution by **ensuring effective implementation of the pilot CO2 emissions trading schemes.** This could be a basis for developing a coherent national approach to carbon pricing. As a national trading system takes time to introduce, it may be quicker and more efficient to tax the carbon content of fuels.
- Take part in the OECD's review of the Inventory of Estimated Budgetary Support and Tax Expenditures for Fossil Fuels, and **participate in the OECD's analysis of energy use and taxation.**
- Pursue an integrated approach to green investment policy to **catalyse and scale up the private investments** needed to achieve green growth objectives.
- **Foster green innovation** through stable and long-term market signals that make polluting activities and technologies more expensive for investors than cleaner alternatives. Complement market-based instruments with policies to improve the overall business environment for innovation, including those that strengthen the IPR regime, which is essential to encourage international research co-operation.
- **Raise environmental standards and improve enforcement and implementation,** including continuous improvement of national standards for motor vehicles and fuels, especially regarding sulphur content, by extending high standards in major cities across the country.

### **OECD work**

The OECD's multidisciplinary structure is a great asset to address linkages between economic, environmental and development policies. The OECD has developed a workflow on Green Growth, which can support China to integrate green growth objectives into broader economic policymaking. For example, as part of the OECD Green Cities programme, the synthesis report [Green Growth in Cities](#) provides the findings from six case studies of urban green growth policies, four at city level (Paris, Chicago, Stockholm, Kitakyushu) and two at the national level (China, Korea).

The OECD has also established a new [Green Growth and Sustainable Development Forum](#), which brings together experts from across different Ministries and a broad range of countries to discuss shared green growth challenges.

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<sup>1</sup> The Climate Group, "Shaping China's Climate Finance Policy", March 2013.



The OECD Green Growth Indicators Database contains selected indicators to support economic and environmental policy analysis for monitoring progress towards green growth.

#### **IEA work**

The International Energy Agency (IEA) has worked with China since 1996, and co-operation has become increasingly close since. In November 2013, China announced its intention to initiate multilateral cooperation with the IEA under an Association initiative. China also signed a third Joint Statement reflecting the strong and growing interest in co-operation, notably on improving energy security; advancing technological R&D in the energy field; enhancing environmental sustainability and improving the quality of energy-related statistics. This will facilitate the wide-ranging co-operative activities of the IEA with numerous counterparts in China. China has also joined 20 IEA Implementing Agreements that foster global co-operation on such diverse energy research topics as nuclear fusion, electric cars and hydrogen storage systems.

#### **NEA work**

The Nuclear Energy Agency (NEA) began establishing relations with China in 2001, with an initial focus on nuclear safety and regulation. Co-operative activities have grown progressively, and a Joint Declaration on Co-operation was signed with the China Atomic Energy Authority (CAEA) in September 2013, opening the door to more in-depth and regular co-operation with OECD/NEA members countries as China actively pursues the development of nuclear power as a low-carbon, baseload energy source to meet its electricity needs. China currently has 20 nuclear power reactors in operation and 28 units under construction, making it the largest nuclear construction programme in the world. As part of China's current Five Year Plan, new nuclear build will continue to be pursued at a steady pace in order to increase the shares of non-fossil fuels. It is also in this context that China participates as a full member in the Multinational Design Evaluation Programme (MDEP) and the Generation IV International Forum (GIF) for which the NEA acts as the Technical Secretariat.

## 8. FURTHER OPENING UP, AND ITS GLOBAL IMPACT ON TRADE AND INVESTMENT

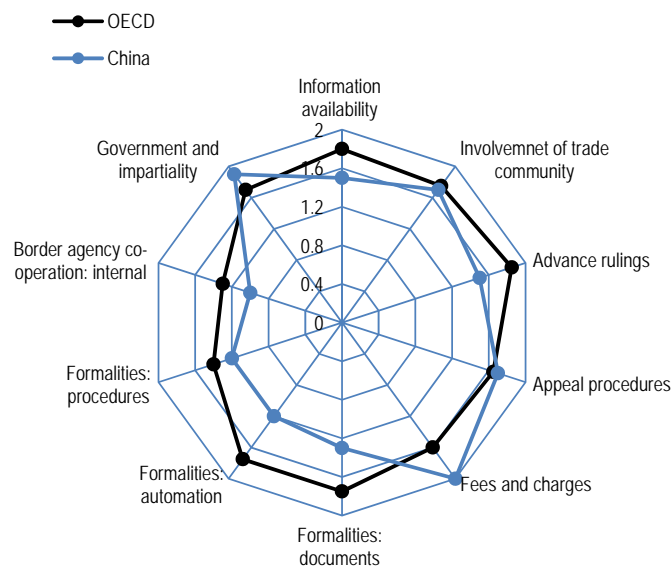
### Challenges

Following accession to the World Trade Organisation (WTO) in 2001, China's economy experienced double-digit growth and continued its transformation towards a modern market-based economy, underpinned by the expansion of foreign trade and investment. In 2010, China became the world's second largest importer and exporter of goods and services and has since steadily narrowed the gap with the United States, even in terms of value added (which excludes goods that are imported and are subsequently exported as finished products). China is also a major recipient of foreign investment (the largest outside the OECD), and became the world's third-largest foreign investor in 2013.

Through trade and investment, China's economy is a key link in international value chains, as evidenced by recent OECD-WTO work on trade in value added. The high share of foreign value-added in China's gross exports reflects its strong position as an assembler and provider of final goods. This share dropped somewhat between 2005 and 2009, as China supplied more domestic value-added to exports. This trend is likely to have continued in recent years, as will be shown when the OECD-WTO Trade in Value Value Added database is updated.

**Figure 8. Reducing border barriers would strengthen China's link in global value chains**

Index, where 2 represents the best score



Source: OECD Trade Facilitation Indicators database.

In recent years, however, China's trade has expanded more modestly and FDI inflows have begun to stabilise. Moreover, to judge by the developments in processing trade, the share of imports in exports has not fallen since 2009. The main sources of the moderation of the expansion of China's market share

in world trade have been rising production costs and exchange rate appreciation. China's commercial performance could be revived by reducing the still relatively high barriers to trade and investment, as well as high levels of state control (Figure 8). The Third Plenary Session of the 18<sup>th</sup> CPC Central Committee in November 2013 issued several recommendations to further open trade and investment.

In this context, China has prioritized further reform to its manufacturing sector and streamlining customs operations. Bottlenecks at the border impact China's trade and investment, and participation in global value chains. According to studies based on the OECD trade facilitation indicators, potential trade cost reductions from practical and relatively inexpensive trade facilitating reforms in upper-middle income countries, such as China, could lower border costs by 13%.

Even though FDI is substantial, there are barriers to foreign equity participation in some manufacturing areas and in major services sectors, such as telecommunications, transport, courier, media, banking, insurance and fund management. Moreover, foreign investors must show net economic benefits to establish a commercial presence, and network industries remain dominated by state-owned enterprises facing little pro-competitive regulation. As a result, indices of services trade restrictiveness, as well as FDI restrictiveness indices, show China among the 25% most restrictive countries globally.

The policy orientations spelled out at the Third Plenum further emphasised widening investment access, including opening up a number of services sectors. In addition, the government recently announced detailed rules for the China (Shanghai) Pilot Free Trade Zone (FTZ) which aims to further open up investment in selected services activities. An important aspect of the zone is that foreign investors only need to seek approval for investments in areas mentioned on a so-called "negative list". In other areas, it suffices to register the application. This change in screening investment projects represents a significant liberalisation of procedures. However, there is still an extensive list of sectors where approval is needed and in some cases investment is still restricted. Taken by itself, this FTZ may have a limited impact on the Chinese economy, but if and when the government reduces the scope of the "negative list" and lowers restrictions on the ownership of companies, the FTZ could have a more positive effect on the economy, especially if it served as the basis for a significant extension in the number of FTZs.

### Main OECD recommendations

- **Further remove tariff barriers and liberalise trade and investment** regimes beyond special zones.
- **Further reduce constraints on international trade and foreign investment**, especially in services.
- Continue efforts to **facilitate trade**, notably in areas of information availability, involvement of the trade community, simplifying and harmonising documents, automation, and streamlining procedures.
- **Reduce government involvement in decisions concerning domestic investments** and apply national treatment to foreign investors.
- **Permit overseas portfolio investment by residents** and facilitate foreign investment by non-public companies.

### OECD work

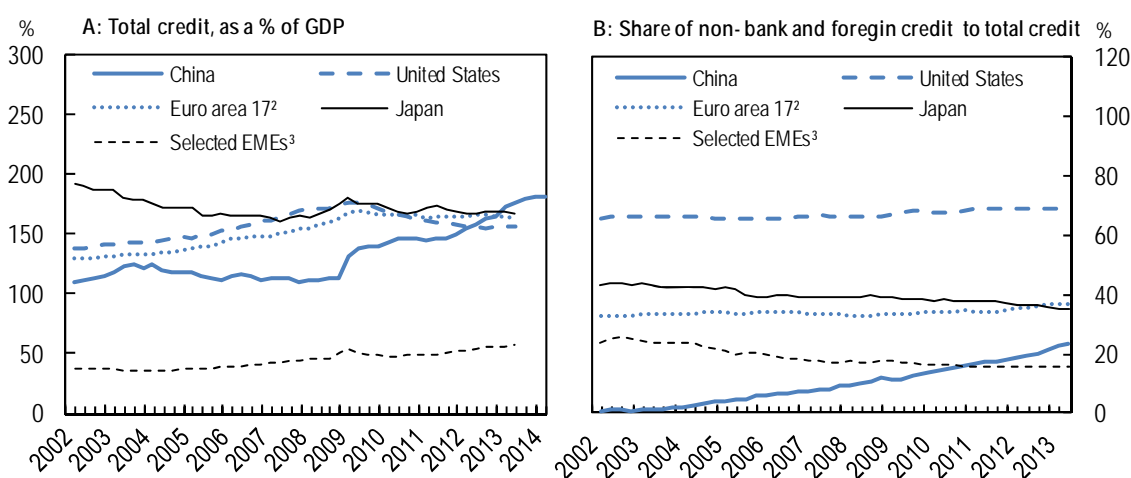
The OECD carries out work on trade and Global Value Chains. The joint OECD–WTO Trade in Value-Added (TiVA) initiative addresses this issue by considering the value added by each country in the production of goods and services that are consumed worldwide. TiVA indicators are designed to better inform policy makers by providing new insights into the commercial relations between nations. The OECD has also developed the *Policy Framework for Investment* which promotes an open, fair, and rules-based international investment regime.

## 9. REINFORCING THE EFFICIENCY AND STABILITY OF THE FINANCIAL SYSTEM

### Challenges

China's financial system is evolving very rapidly. Total credit has grown rapidly since 2009 (Figure 9). Since 2007, interest rates are being set more by market forces and less through administrative decisions. The central bank has taken many steps to liberalise the allocation of credit by creating new markets, improving the functioning of existing markets and introducing new instruments. This resulted in nearly 43% of the flow of total credit being provided through non-bank channels by 2013. The stock of credit provided from outside the banking sector is nevertheless still lower than in most OECD countries (Figure 9).

**Figure 9. Total credit to the non-financial private sector <sup>1</sup>**



1. The data refers to credit to the non-financial sector of the economy that includes corporations and households. Corporations include both state-controlled companies and private companies. For China, credit data have been extended up to 2014Q1 by using growth in total social financing as a proxy.

2. Euro area excludes Latvia for the whole period.

3. The selected EMEs are Argentina, Brazil, India, Indonesia, Malaysia, Mexico, Russia, South Africa and Thailand. The overall ratio is the average of the country ratios using 2005 GDP at market exchange rates as weights.

Source: BIS, *Credit to the private non-financial sector* database; Datastream; Eurostat; World Bank; and OECD Analytical Database.

Financial transactions with non-residents have been liberalised gradually but remain strictly controlled. An offshore market for the renminbi has been introduced, with small, but growing, capital flows into mainland China. And while the exchange rate is still determined by the central bank, the bands of fluctuation of the currency continue to be gradually expanded.

The central bank continues to set the very short-term interest rate through quantitative instruments, such as loan quotas. As a result, short-term interest rates are far more volatile than in developed markets, which reduces their information content as a signalling device for the transmission of monetary

policy. Recently, the central bank announced that deposit interest rate liberalisation could be achieved within a couple of years

Moving to more market-determined rates should help allocate capital more efficiently but involves some challenges. Financial deregulation in mature economies has often produced surges in credit that have ultimately proved to be unsustainable, and this is a risk for China as well. Credit extended by the non-bank sector therefore needs to be monitored very closely. Chinese non-bank financial institutions often lend to sectors, such as local government investment corporations and real estate developers, where bank lending is strictly controlled and hence are facilitating regulatory arbitrage. Moreover, many of the new products in the non-bank sector have a significant maturity mismatch between assets and liabilities that poses a risk to their sponsoring institutions in the event of a crisis.

Moving to a less strictly regulated environment also calls for better protection of depositors and small investors. For banks, especially small ones, deposit insurance is needed. For non-bank products, better asset diversification needs to be imposed in order to reduce default risk to the investor. In addition, investors in high-yield investments need to understand that they are not insulated from losses, as in the country's first corporate bond default in March 2014.

Given that lending quotas have existed for many years, deregulation is likely to result in an increase in the equilibrium interest rate in the economy. While this would benefit household savings, it might also put upward pressure on the exchange rate, when, as currently planned, intervention in foreign exchange rate markets has basically ended. Careful sequencing of capital account liberalisation could avoid such risks. In particular, international experience suggests that liberalisation of outflows of portfolio investment might be called for early on in the process. Efforts to improve disclosure by financial institutions and strengthen financial consumer protection should also be pursued, together with programmes to improve financial literacy in the population.

### Main policy recommendations

- Establish a system of **deposit insurance**.
- Impose **greater portfolio diversification requirements on investment products** sold to the public.
- **Guard against regulatory arbitrage** that artificially reduces the capital adequacy of banks.
- Move towards using interest rates to control the economy by establishing a **progressively narrower corridor for short-term borrowing and lending rates between banks**.
- **Sequence capital account liberalisation** in a way that helps limit exchange rate appreciation and arbitrage between domestic and foreign borrowing.

### OECD work

The OECD promotes efficient, open, stable and sound market-oriented financial systems, based on high transparency, confidence and integrity. It monitors and surveys current market developments and structural changes, and assesses and develops reform measures related to banking, securities and institutional investors (in particular, insurance companies and private pension schemes). In addition, it facilitates policy dialogue and exchange of experiences (see [www.oecd.org/daf/fin](http://www.oecd.org/daf/fin) for more information).

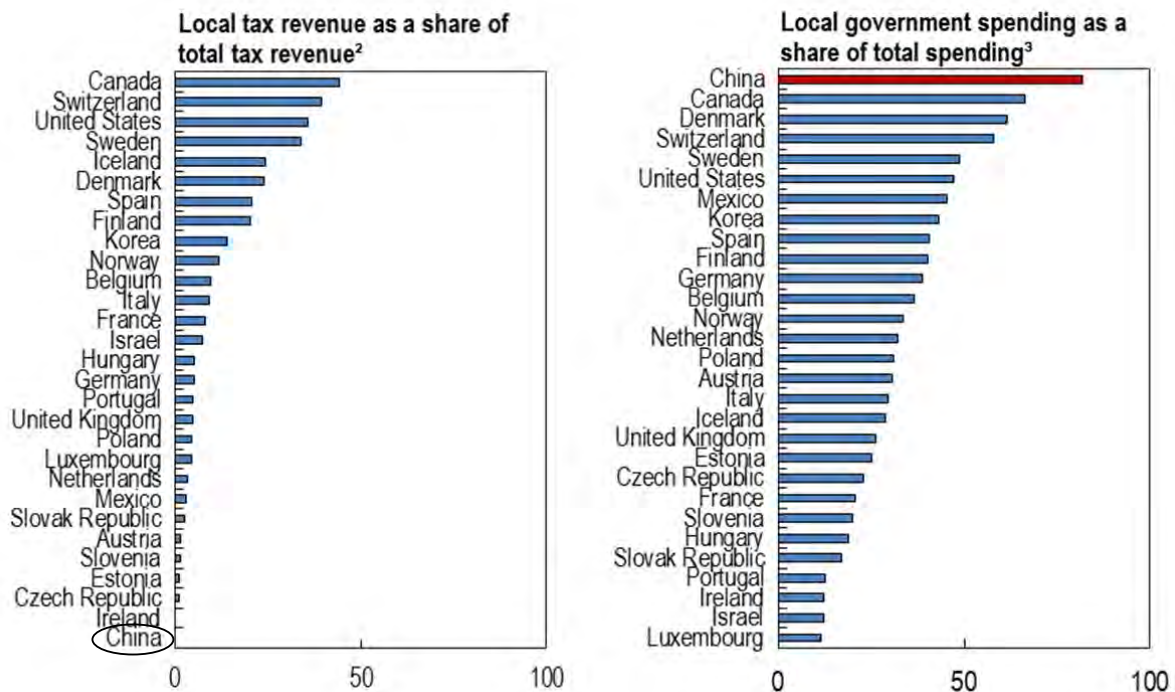
China participates in the OECD/Asian Development Bank Institute Roundtable on Capital Market Reform in Asia and the OECD Global Forum on Public Debt Management, as well as the OECD/World Bank/IMF Global Bond Market Forum. China is member of the OECD International Network on Financial Education and is developing a National Strategy of Financial Education. China has attended the first Asian Roundtable on Financial Consumer Protection and has contributed to and supported the work of the G20/OECD Task Force on Financial Consumer Protection.

## 10. ENHANCING THE FISCAL RESPONSIBILITY OF LOCAL AUTHORITIES

### Challenges

Since the 1994 fiscal reform, the fiscal revenue of China's local authorities has grown less than the central government's. Even so, local authorities are responsible for executing the bulk of public expenditure. As a result, the central government transfers 85% of its tax revenue to subnational governments, mostly at the provincial level. Each level of local government then makes transfers to lower levels of government. Overall, subnational governments are highly dependent on transfers, which represent two-thirds of the tax revenue for provincial and prefectural governments and more than twice the tax revenue of districts and counties. Local governments have scant autonomy in terms of tax raising capability. Indeed, when compared internationally, local governments in China have the lowest tax autonomy whilst having the highest responsibility for expenditure (Figure 10).

**Figure 10. Extent of local government tax autonomy and spending<sup>1</sup>**



Notes:

1. Data for China refers to national government only and excludes the social security system.
2. Share of locally legislated tax revenue as a share of consolidated general government tax revenue.
3. Local government spending share is expressed as a share of consolidated general government expenditure.

Source: OECD, Fiscal Decentralisation database.

Local governments do have the right to sell assets that they own, including all urban land. The profit from the sale of residential land-use rights has become a major source of revenue for the construction of local infrastructure, as governments cannot use this revenue to finance consumption. In 2009, land sale



revenues (net of compensation and improvement costs) accounted for 10% of total local authority revenue, rising to 17% for prefectural cities. This share has risen further on the back of property market buoyancy. Using increased land values to finance transport and other urban facilities is economically justified but, as currently implemented, raises important challenges (see chapter 2).

Overall, the local authorities face a conservative set of financial regulations whose constraints they have easily circumvented. Local authorities can only borrow a very limited amount through the central government, although they can run deficits by using cash balances. However, public service units that are nominally independent of local authorities are able to borrow in their own right. As well, investment companies wholly owned by local governments have borrowed in order to finance construction projects. Given the limited development of financial markets, most of this borrowing has been for maturities of less than five years, requiring frequent refinancing over the life of investment projects.

The first challenge facing the central government is to put local government borrowing on a sustainable basis, as the borrowing requirements of local government amounted to 4½% of GDP in the first half of 2013 and debt ratios were high. Based on data revealed in bond prospectuses, four provinces (Tianjin, Chongqing, Qinghai and Shanghai) have debt ratios of between 60% and 75% of local GDP. In more market-oriented provinces, the total debt ratio is between 10% and 25% of GDP (Shandong, Guangdong, Fujian, and Zhejiang). Such ratios imply that the debt-to-tax-revenue ratio was close to five in the first group but less than two in the second. In the OECD area, the unweighted average was 2.3 at the national level. The differences between Chinese provinces suggest that over-borrowing is more a problem of political choice than an inherent feature of the current governance structure. Nonetheless, a resolution mechanism is needed in those cases where local debt is unsustainable. Prompt release of debt data for each local authority would improve transparency. Moreover, if local governments were to use a consolidated accrual-based accounting system, including all off budget entities, a better picture of local indebtedness would emerge. Setting budgets three months before the start of the fiscal year, rather than three months after, as is the case now, would also be in line with best international practice.

A further challenge is to establish a better balance between the tax revenues of central and local government. Currently there is a large amount of churning – tax revenues in a province accrue to the central government only to be returned in the form of transfers. This argues either for a change in the tax sharing coefficients or for an increase in non-earmarked transfers given that local authorities are likely to know local problems better than the central government.

### Selected policy recommendations

- Establish a **resolution mechanism** for total local authority debt.
- Put consolidated **local borrowing on a sustainable basis**.
- **Move local authority accounting onto an accrual basis**, with consolidation of off-budget entities and quarterly upward reporting with public release of data.
- **Allow local authorities to keep a higher proportion of tax revenues** and raise the proportion of non-earmarked transfers from central to local government.
- **Develop longer maturity lending for infrastructure**.

### OECD work

The OECD carries out work on fiscal responsibility via its Senior Budget Officials Committee, which works on modernising the structure of government accounting, and the OECD Fiscal Network, which produces analyses on relations between different levels of government. Closer collaboration with these groups could help China in its reforms to achieve greater responsibility of its local authorities.

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