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**Rebuilding Government for the 21st Century:  
Can China Incrementally Reform the Public Sector?**

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## **Abstract**

China's transition to a market economy has achieved remarkable economic successes over the past three decades. However, reform of the public sector has lagged far behind. The rash of scandals in recent years involving tainted infant formulas, fake pharmaceuticals, chemical spills, etc., point to gaps in the government's capacity to protect public safety. Corruption and inequalities are adding to social conflicts. Strengthening public sector performance is critical to ensuring China has an effective and credible government to leading it into the 21<sup>st</sup> Century.

This paper examines the prospects of public sector reform and argues that more incremental reform will not work. This argument is built on reviewing the retrenchment of government during the 1980s-1990s, which had been dictated by the sharp fall in government revenues from 35 to 11 percent of GDP. As budgetary resources dwindled, and with government unwilling to cut departments, employees, or services, the solution was to allow government agencies and service providers to levy user charges and use their assets to generate nonbudgetary incomes. These concessions gave birth to the revenue-seeking orientation of the public sector and sowed the seeds of current problems of inequality and weak governance. Since 2000, the government has implemented numerous programs of public sector reform – budget reform, treasury reform, procurement reform, streamlining of rural government, etc. These have brought improvements and made government more transparent. The recent programs of free rural education, rural cooperative medical schemes, minimum living stipends (低保), etc., are transferring substantial new resources to funding services at the grassroots levels and improving fairness. However, until the incentive structure for government agencies and public institutions (事业单位) is fundamentally altered, this top-down reform of the public sector will have limited effect.

## **Biography**

Christine Wong is a Senior Fellow in Chinese Studies at the School of Interdisciplinary and Area Studies and the Said Business School. Before joining Oxford University in September 2007, she was the Henry M. Jackson Professor of International Studies at the University of Washington's Henry M. Jackson School of International Studies. She has also taught in at the University of California, Santa Cruz; University of California, Berkeley; and Mount Holyoke College (Massachusetts), in the economics departments. Outside of academia, she has held positions as Senior Economist in the World Bank Office in Beijing, and Resident Scholar at the Asian Development Bank (Manila). She received her Bachelor of Science degree from the Massachusetts Institute of Technology and her Ph.D. from the University of California, Berkeley, both in Economics.

Christine's research focuses on issues of public finance and public sector reform in China. She has published widely on economic reform, fiscal reform, rural industrialization, and the problems of intergovernmental relations in China. Her most recent publication was *Paying for Progress in China: Public Finance, Human Welfare and Changing Patterns of Inequality* (co-edited with Vivienne Shue), London, Routledge, 2007. She has worked on numerous World Bank studies of fiscal policy issues, including *China: Public Services for Building The New Socialist Countryside* (2007); *China: Extending Public Finance to Rural Areas* (2006); and *Reforming Intergovernmental Finance in China: a Study of the Northeast* (2007). She was principal author of the World Bank report, *China: National Development and Subnational Finance, a Review of Provincial Expenditures* (April 2002). She is also editor and principal author of two previous books on China's public finance: *Financing Local Government in the People's Republic of China*, Oxford University Press, 1997; and *Fiscal Management and Economic Reform in the People's Republic of China* (with

Christopher Heady and Wing T. Woo), Oxford University Press, 1995, 1996.

## **Rebuilding Government for the 21<sup>st</sup> Century: Can China Incrementally Reform the Public Sector?<sup>1</sup>**

### **1. Introduction**

Over the past three decades, China has undergone a spectacularly successful transition to a market economy. Though far from complete, this transition has been remarkable for sustaining a high rate of economic growth that is virtually unprecedented in world history, bringing structural adjustments to the economy, raising productivity and living standards in all regions and sectors, and transforming China from “sick man of Asia” to economic powerhouse.<sup>2</sup> This record of achievement is marred, however, and the government faces significant challenges ahead. Inequality has risen sharply across regions, sectors, and social groups.<sup>3</sup> Corruption is rampant. Through the 1990s popular protests have grown in size and frequency, as citizens (mostly farmers) protested excessive fees and levies and, increasingly, illegal land takings and evictions. While many of these might have been reflections of social dislocations of China’s rapid growth and urbanization, the country has also been rocked by a series of scandals in recent years, of which the unfolding saga of tainted milk powder from Sanlu, the largest and most reputable milk producer in the country, is only the latest in a string of stories that went from fake infant formula causing the death of hundreds of babies in 2004,<sup>4</sup> to the 2005 chemical

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<sup>1</sup> In this paper I have drawn from several World Bank studies in which I participated over the past five years. I am indebted to the many colleagues with whom I worked on these studies, most importantly Achim Fock (rural public finance and reform of rural public services), Dana Weist (intergovernmental fiscal reform in the Northeast), and Zhang Chunlin (reform of public service units). I also thank Carl Riskin for comments on the first draft.

<sup>2</sup> There is a veritable cottage industry of articles and books extolling China’s economic successes. See Naughton (2007) and Brandt and Rawski (2008) for comprehensive treatments of China’s economic development over the past three decades.

<sup>3</sup> See, for examples, Shue and Wong (2007), Ravallion and Chen (2004), UNDP (2005).

<sup>4</sup> Chinese media reports said that around 200 babies in Anhui alone were fed formula milk of little nutritional value. An initial inquiry showed 45 types of substandard powder were on sale in Fuyang City, Anhui, produced by 141 factories across China, Xinhua said. BBC news online, Thursday, 22

spills into the Songhuajiang that contaminated water supplies to major population centers in the Northeast,<sup>5</sup> the mislabelling of exported chemicals that turned toothpastes, pet food and pharmaceuticals into deadly poisons, etc. These are worrisome signs of government weakness and outright failure to perform the core functions of ensuring fairness, public safety and providing consumer protection. Some observers have pointed to the recent trend of violent protests as indicative of a growing “crisis of confidence”, where the public is increasingly distrustful of government and public institutions.<sup>6</sup>

To the government’s credit, it is responding. Premier Wen Jiabao has admitted “..the government was partly responsible for the tainted milk scandal,” and vowed to take corrective action.<sup>7</sup> Strengthening public sector performance is clearly seen as a critical component of the reforms needed to ensure an effective and credible government leading China into the 21<sup>st</sup> Century.

In this paper I assess the prospects of public sector reform in China. After this introduction, in Section 2 I review the retrenchment of government during the 1980s-1990s. This process was highly constrained since, under the gradualist approach to market reform, the need to preserve the status quo and maintain social stability precluded substantial downsizing of government services or departments. I trace the roots of the current problems of inequality and weak governance to the legacies of the incremental cutbacks and the concessions made by the government during this period. In Sections 3 and 4 I will discuss separately the impact of this retrenchment as two types of effects – Section 3 details the direct, measurable

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April, 2004; downloaded October 19, 2008.

<sup>5</sup> In November 2005, a chemical plant explosion in Jinlin Province caused a leakage of benzene into the Songhuajiang River. As a result, water supplies to Harbin, the tenth largest city in China, with a population of 5.5 million, were cut off for a number of days.

<sup>6</sup> See, for examples, Yu Jianrong (2008) and Fewsmith (2008), both writing about an incident on 28 June 2008, where at least 10,000 people, and perhaps as many as 30,000, according to some reports, participated in the riot in Wengan County in southwestern Guizhou, the poorest province in China, to protest a suspected police cover-up over the death of a girl. In the riot, police cars were overturned and burnt and the Public Security Bureau building set on fire. Yu, in particular, has studied the trend toward crowd volatility over the past several years as a significant new social phenomenon in China.

<sup>7</sup> New York Times October 19, 2008, page A9.

changes, and Section 4 those with longer term impact on shaping the economic system and incentives. In Section 5 I conclude by highlighting the difficulties of imposing a top-down reform of the public sector under the present structure of incentives facing local governments, public institutions, and civil servants. Since 2000, the government has implemented numerous programs of public sector reform – budget reform, treasury reform, procurement reform, streamlining of rural government, etc. These have brought improvements and made government more transparent. The recent programs of free rural education, rural cooperative medical schemes, minimum living stipends (低保), etc., are transferring substantial new resources to funding services at the grassroots levels and improving fairness. However, until the incentive structure for government agencies and public institutions (事业单位) is fundamentally altered, this top-down reform of the public sector will likely have only limited effect.

## **2. Withdrawal of government: 1980s-1990s**

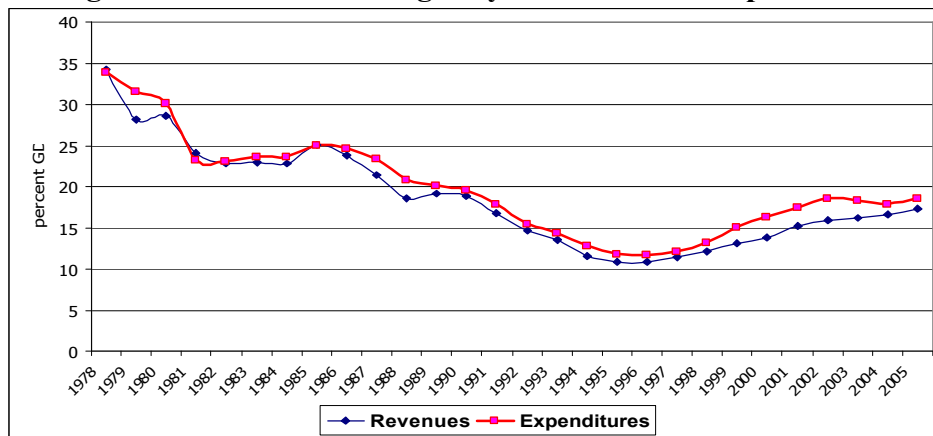
By definition, market reform means reducing the reach of government and turning economic management over to market forces. In the process, the government share of GDP shrinks, as more resources are left in private hands. In China market reforms had been preceded by more than a decade of political strife and economic stagnation caused by the ultra-leftist policies of the Cultural Revolution. Dissatisfaction with centralized management and state control was rife, and the relaxation of administrative controls and curtailing of government was much welcomed. As it happened, though, the government's control over resources fell more swiftly and further than expected, and revenue constraints began to dictate the pace and depth of reform from the mid-1980s.

*Retrenchment was dictated by fiscal decline.* From the start of market reforms, dismantling the planning apparatus had led quickly to an erosion of the government's main revenue mechanism – SOE profits, and government revenues

went into a steep decline, falling from 35 percent of GDP in 1978 to less than 20 percent by the end of the 1980s. This decline continued into the 1990s, and indeed accelerated from the mid-1980s onward, reaching a nadir of just 11 percent in 1996.

Throughout this decline, the government appears to have exercised remarkable fiscal discipline – by cutting expenditures largely in line with revenues and keeping deficits small. This is shown in Figure A. (It should be noted that the painful adjustment was ameliorated by rapid economic growth, as the budget grew in absolute terms throughout the 1980s and 1990s even as its share in GDP plunged – see Table 1 below).

**Figure A. Trends in Budgetary Revenues and Expenditures.**



Source: CSY, with data adjusted to international definition.

This discipline was illusory, however. In fact, the retrenchment was implemented with neither a clear strategy nor a consensus for redrawing the public-private divide in the new market economy that China would become. A perusal of official documents during the 1980s and early 1990s turned up no sustained discussion of how to identify areas or services where the government’s role could/should be reduced. In the 1980s nearly all discussion was centered on reviving the profitability of state-owned enterprises. In the late 1980s and early 1990s, the focus turned to reining in local governments to prevent them giving unauthorized tax concessions to local SOEs and thus depressing tax collections.

Through these two decades, nearly all attention was focused on the revenue-side of the budget, of how to revive collections.<sup>8</sup> There was, at least in the public finance literature, little discussion of opening up public services such as education, health, and even sports and research, to private participation. Privatization of public service providers was not proposed until the late 1990s.

This was not surprising under the gradualist approach adopted in China's transition, which depended on building support for market reforms by proceeding incrementally while preserving the status quo – protecting vested interests and avoiding creating “losers.” In the absence of a clear strategy, the retrenchment proceeded without cutting personnel or government departments.<sup>9</sup> Instead, the government sought to defer spending on maintenance and new investments, and select cuts that inflicted the least pain. After those were exhausted, cuts were distributed more or less across-the-board. The resultant changes can be seen in Table 1.

First to go was investment spending, especially for new projects. In Table 1, I have grouped together the budgetary items of capital construction, working capital, technological upgrading, geological prospecting and urban maintenance and construction under the heading of “investment spending”, and this category had accounted for a combined total of 16.2 percent of GDP in 1978 in the central and local government budgets. During 1978 to 1988, the government shed 11 percent of GDP from budgetary expenditures by requiring SOEs to borrow from the banks for

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<sup>8</sup> Based on writings and speeches of Wang Bingqian, who was Minister of Finance during 1980-1992.

<sup>9</sup> Most famously, the planning commission remains a powerful agency in China thirty years after the start of market reform, where it is “first among equals” among the superministries. Although its name has changed to the National Development and Reform Commission, to shed the “planning” label, and its core mission remains that of allocating capital investments financed by the budget, even though the share of budgetary funds is now a minor portion of total investments. The Price Commission, another powerful agency under the planned economy, was never abolished, although demoted to a department under the NDRC. Even a lowly agency like the Loudspeaker Team, which was in charge of maintaining the loudspeakers for broadcasting propaganda and instructions to the fields under collective agriculture before radio and television became widely available in rural China, remains in existence as a government agency today. While there have been several rounds of downsizing campaigns for



investment as well as for working capital, and deferring new investments (Wong 1991).<sup>10</sup> National defense spending was also cut, from 4.6 percent of GDP to 1.4 percent during this period, saving another 3 percent. These cuts were relatively easy because they were mostly congruent with reform objectives. For example, moving enterprise investment expenditures off the budget was consistent with reforms that sought to wean SOEs from direct government control. Similarly, cutting defense spending was acceptable given the implied friendlier international climate that had underpinned the Open Door policy, a core part of market reform in China.

For other expenditure items, not only were cuts harder to implement, but on the contrary, there were great pressures to increase spending. For example, the demand for social services and safety net programs had greatly increased under market reforms as many economic risks were being transferred from the state and enterprises to individuals. Price and enterprise loss subsidies rose rapidly during the early-mid 1980s, as government tried to cushion the impact of price liberalization and keep SOEs afloat. Even government administration had to expand: not only did costs rise with the wage increases that followed the redistribution of factor incomes under market reform, but the market also imposed new administrative requirements. For example, a whole new layer of government was added when the 1985 State Council decision called for setting up township governments to take over administrative tasks formerly performed by the agricultural people's communes and their subordinate brigades and teams. The task of collecting agricultural taxes alone had expanded from a taxpayer roll of 6 million production teams to one with more than 200 million rural households. As can be seen in Table 1, through the fiscal

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civil servants, they were not explicitly tied to cost-cutting measures. In any case, they have been notably unsuccessful.

<sup>10</sup> The figures cited in this paper differ somewhat from those in Wong (1991) because the GDP data have been revised by the Chinese government. The figures used here are based on the updated GDP series.

decline, social spending fell from 3.7 percent of GDP in 1978, to 3.5 percent in 1988, to 2.6 percent in 1995. Government administration increased, but only slightly, from 1.3 percent to 1.6 percent in 1988 and 1.4 percent in 1995.

**Table 1. Changes in Central and Local Budgets, 1978-2006**

I. Budgetary Expenditures	1978		1988		1995		2006	
	Central	Local	Central	Local	Central	Local	Central	Local
<b>Total (Billions RMB in 1978 prices)</b>	<b>57.7</b>	<b>66.1</b>	<b>60.8</b>	<b>109.8</b>	<b>103</b>	<b>128.7</b>	<b>212.8</b>	<b>649.3</b>
Investment	29.6	29.7	32	14.2	15.4	25.7	41.8	127.9
Industry, Transport & Commerce	1	0.8	0.7	1.5	0.9	1.7	2.9	9.5
Agriculture	0.2	7.5	0.8	8.1	1.2	9.7	4.1	41.8
Social	1.3	11.9	3.5	26.4	3.7	36.1	20.5	201.5
National Defense	16.1	0.7	12.2	0.1	15.9	0.1	62.6	0.7
Government Administration	0.4	4.5	2.2	11.3	1.8	20.2	13.9	105.8
Debt Servicing	0	0	4.3	0	22.2	0	20.7	0
Subsidies	4.5	7.1	10.7	32.5	10.8	13.7	12.3	20.9
Others	3.5	3.9	2.2	15.1	31.1	21.5	33.9	141.2
<b>II. Shares of Total Budgetary Expenditures (%)</b>	<b>46.6</b>	<b>53.4</b>	<b>35.7</b>	<b>64.3</b>	<b>44.5*</b>	<b>55.5</b>	<b>24.7</b>	<b>75.3</b>
<b>III. Budgetary Expenditures as % GDP</b>								
<b>Total</b>	<b>15.8</b>	<b>18.1</b>	<b>7.1</b>	<b>12.9</b>	<b>6.7</b>	<b>8.4</b>	<b>4.8</b>	<b>14.5</b>
Investment	8.1	8.1	3.8	1.7	1	1.7	0.9	2.9
Industry, Transport & Commerce	0.3	0.2	0.1	0.2	0.1	0.1	0.1	0.2
Agriculture	0.1	2.1	0.1	1	0.1	0.6	0.1	0.9
Social	0.4	3.3	0.4	3.1	0.2	2.4	0.5	4.5
National Defense	4.4	0.2	1.4	0	1	0	1.4	0
Government Administration	0.1	1.2	0.3	1.3	0.1	1.3	0.3	2.4
Debt Servicing	0	0	0.5	0	1.5	0	0.5	0
Subsidies	1.2	1.9	1.3	3.8	0.7	0.9	0.3	0.5
Others	1	1.1	0.3	1.8	2	1.4	0.8	3.2

Sources: China Statistics Yearbook (various years), New China 55 Years Statistics, and MOF dataset for 2007.

\* The central share in 1995 was inflated by very large outlays in debt servicing, which absorbed more than one-fifth of central revenues.

### **3. Outcomes of retrenchment**

The cost of retrenchment was felt everywhere. Pushing capital spending off the budget but keeping SOEs from bankruptcy created contingent liabilities in the financial sector that necessitated a huge cleanup some twenty years later through the creation of asset management companies to mop up bad debts. Here I highlight four outcomes that followed directly from the long fiscal decline and expenditure cuts: a) the collapse of redistribution, b) decentralization by default, c) the underprovision of social services, and d) the growing reliance on user charges and business incomes.

#### **A. Collapse of redistribution**

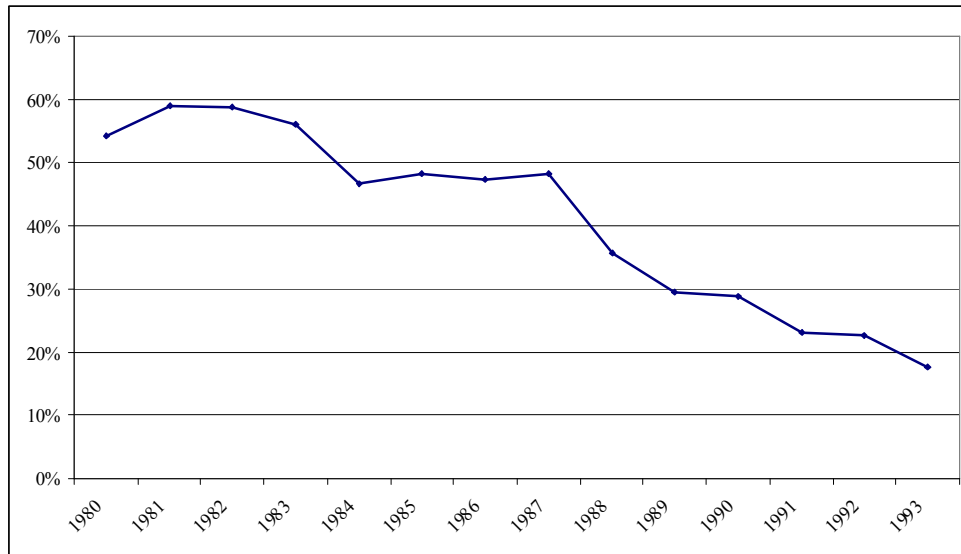
Fiscal decline during the 1980s and early-1990s obviously eroded the central government's ability and willingness to provide assistance to local governments in poor regions. The first significant policy decision on the reduction of support came in 1987, when the government announced that budgetary transfers to poor provinces (then called quota subsidies) would for the next few years remain frozen at the 1986 level of ¥ 8.6 billion.<sup>11</sup> By holding the subsidy constant in nominal terms, the government in effect allowed them to be quickly eroded in value under the high rates of inflation that were prevalent in the late 1980s. In constant 1986 yuan, the subsidies were worth RMB 8.0 billion in 1987, 6.8 billion in 1988, and 5.7 billion in 1989. By 1994, they were equivalent to only 3.5 billion 1986-yuan.<sup>12</sup> The effect of this on Guizhou, the poorest province in per capita GDP terms, can be seen in Figure B, where the share of provincial expenditures financed by transfers is shown to fall from 60 percent at the outset of transition, to only 18 percent in 1993.

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<sup>11</sup> 1987 decision...

<sup>12</sup> These figures assume quota subsidies of 8.6 billion yuan and deflated by CPI. In fact the reported total rose slightly because of other adjustments in the system that are unrelated to equalization objectives.

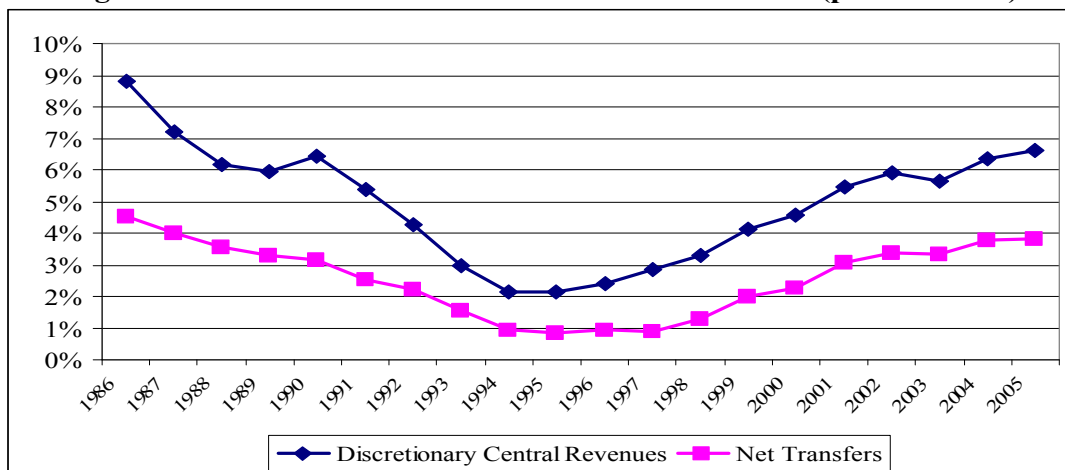
**Figure B. The share of provincial expenditures financed by transfers**



Source: calculated from data from author interview with Guizhou Finance Department, 1997.

Data available for all transfers are shown in Figure C, showing a step decline that followed the trend for central revenues. Transfers began to rise only after 1997, when central revenues began their recovery. At the nadir, net transfers had fallen to 1 percent of GDP in 1994, and remained at that level for several years of the mid-1990s.

**Figure C. Trends in Central Revenues and Transfers (percent GDP)**



Source: Wong (1997), CFY and Li and Xu (2006).

In fact, the collapse of transfers was far more drastic than that depicted above, since *measured transfers* were only a small part of the redistribution that took place

under the previous regime, and the definition of transfers had changed with the revenue-sharing system introduced under the Tax Sharing System reform in 1994. Previously, most transfers were hidden under the system of negotiated revenue sharing, where poor provinces were allowed to keep a higher portion of revenues collected in their regions, while rich provinces were obligated to turn over higher portions to the central government. For example, Shanghai, the richest provincial unit, annually remitted over 80-85 percent of their collections. In 1987, Jiangsu remitted 55 percent, Zhejiang 39 percent, and Guangdong 8 percent.<sup>13</sup> Under that system, only eight provinces regularly received what were called “subsidies,” since they could not meet minimum expenditure needs even after being assigned 100 percent of their collected revenues.<sup>14</sup> The other transfers -- “earmarked subsidies” and “final account subsidies”, were designed to implement central programs and compensate for policy changes. They were not tied to equalization concerns, and were in the aggregate not equalizing (Wong and West 1997, World Bank 2002).

The Tax Sharing System introduced in 1994 had brought two significant changes to revenue sharing between central and local governments: a reassignment of revenues that saw the central share rise from 22 percent to more than 50 percent of the total, and a shift from the sharing of general revenues to a system of tax assignment and tax sharing. Under the new system, the central and local governments each had clearly assigned “own revenues”, and all transfers became explicit. This expanded the scope of “transfers” and *ceteris paribus*, should have

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<sup>13</sup> For a discussion of the detailed workings of this revenue sharing regime, see Wong, Heady, and Woo 1995, pp. 85-99.

<sup>14</sup> The 8 provinces were: Guangxi, Guizhou, Inner Mongolia, Ningxia, Qinghai, Tibet, Xinjiang, and Yunnan; all of them with high proportions of ethnic minority populations. The term “transfers” (转移支付) was adopted by the Ministry of Finance only over the past decade or so. Previously, they used the term “subsidies” (补贴).

substantially increased transfers. Indeed, from 1994 onward, all provincial units, including Shanghai and Beijing, became recipients of central “transfers.”<sup>15</sup> In this light, the collapse of redistribution toward poor regions can be seen as precipitous.

### **B. Decentralization by default**

By expenditure shares, China was already highly decentralized at the outset of reform in 1978, with local (subnational) governments accounting for 53 percent of budgetary expenditures. As shown by figures in Table 1 (Panel II), the process of ad hoc retrenchment described above had produced a further decentralization of expenditures throughout the 1980s and 1990s, and by 2006 local governments accounted for three-quarters of the total. I call this process decentralization by default, because it had occurred by incremental, reactive changes on the revenue- and expenditure sides that were largely uncoordinated.

On the expenditure-side, under the current division of assignments, the central government is mainly responsible for economic development (including investment expenditures), national defense and diplomacy; local governments are mainly responsible for day-to-day administration, and the provision of social services. This division of labor meant that in the 1980s, most of the easy expenditure cuts were made in the central government budget, while most of the pressures for expenditure increases fell on local governments, which also had to absorb the additional burden of services being devolved from SOEs, including pensions, schools, and health institutions.<sup>16</sup> This dynamic drove the fiscal system toward decentralization, as

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<sup>15</sup> The rich provinces receive mostly tax rebates based on increased VAT and excise tax collections. Since around 2003 the Ministry of Finance has attempted to exclude tax rebates (around 40 percent of total transfers) from the reporting of “transfers”, but statistical reports continue to count them.

<sup>16</sup> This was the subject of my paper in 1991, where I showed that the ongoing fiscal decentralization did not benefit local governments, as was widely perceived, because the pressures emerging from fiscal decline and expenditure needs of the changing economy were distributed asymmetrically, and were falling more heavily on local governments (Wong 1991).

*expenditure shares* shifted to local governments, even as expenditures were falling for both central and local governments in terms of GDP shares.

On the revenue-side, worry over the erosion of central control over resources led to a progressive de-linking of revenue assignments from expenditure needs considerations. Through the early-mid-1980s, the government had interpreted its fiscal problems as problems of state-owned enterprises, and reviving the profitability of SOEs and finding more efficient means of taxing them were the focus of reform efforts (Wong 1992). When these efforts proved ineffectual, the government began to suspect local governments, especially in rich regions, of colluding with SOEs to avoid sharing revenues with poorer regions (Wong, Heady, Woo 1995). To stop the hemorrhage and lock in revenues for central coffers, in 1988 the central government retreated to a system of fiscal contracts for revenue sharing with the provinces. The contracts stipulated a lumpsum remittance (or subsidy) for each province, to increase annually by an agreed rate that left a progressively higher portion to local governments. In exchange, these contracts also turned over responsibility for meeting expenditure requirements to the provinces, to be financed from their “own”, retained revenues. This change had altered the Chinese fiscal system fundamentally. By severing the link between revenue- and expenditure assignments, it turned the system from one based on a delegation of responsibilities to real decentralization.

### **C. Underprovision of social services**

In the initial years of the transition, the government had increased spending on public services, designating as priorities education, health, poverty alleviation, environmental protection, and social insurance. In education, public spending on recurrent expenditures had risen from 1.8 percent of GDP in 1978 to 2.2 percent in 1982. In health, it rose from 1 percent to 1.3 percent during the same period. As



fiscal decline took hold, however, this effort to increase public spending on social sectors became a lost cause – even as the proportion of budgetary resources devoted to education was more than doubled from 5.8 percent to 13.1 percent during 1978-1995, its share in gross domestic product fell, to 1.5 percent in 1995.<sup>17</sup> Public health spending showed a similar trend, declining to 0.64 percent of GDP in 1995.<sup>18</sup> Elsewhere, while China strove hard to increase spending on pollution control, from 0.4 percent of GDP in 1980 to 0.67 percent in 1992, this was far from adequate in the face of rapid industrialization (World Bank 1996).

As a result of these funding problems, China's public spending on social services is low. Compared to other Asian countries, or even to other lower-middle income countries, China's expenditures on education, hovering around 2-2.5 percent of GDP throughout the 1980s and most of the 1990s, were far below the levels of its Asian neighbors, and below the average for lower-middle income countries worldwide.<sup>19</sup> They also fell short of the goals set in the Education Law (1986), which had called for reaching 4 percent of GDP by 2000. Likewise, China's public spending on health, at 1.9 percent of GDP, is one-quarter below the "predicted value" of 2.4 percent based on international comparisons, where a strong correlation between per capita GDP and health spending is commonly observed (Smith, Wong and Zhao 2005). In a 1996 report, the World Bank estimated that China faced a spending gap in critical social services that was equal to nearly 5 percent of GDP.<sup>20</sup>

#### **D. Increased reliance on user charging and "business incomes"**

With budgetary resources dwindling, and with government unwilling to cut

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<sup>17</sup> Calculated from data from CSY 1998 and 2006. These figures are based on the new GDP figures, which had raised GDP estimates by more than one-third.

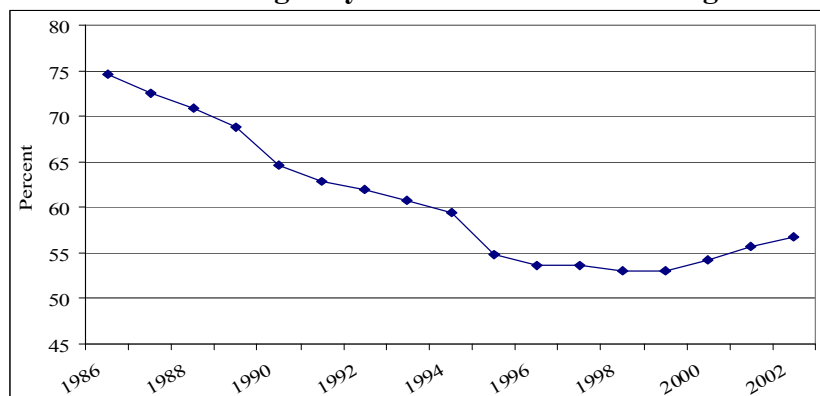
<sup>18</sup> Calculated from National Health Statistics.

<sup>19</sup> OECD data --

<sup>20</sup> World Bank (1996).

services, departments, or employees, the only solution was to allow local governments and service providers to seek supplementary incomes by levying user charges and using their assets creatively. Data that is available on public service units (PSUs) shows the share of public funding fell sharply across all services. Figure D illustrates the situation for education, where the share of budgetary resources in total funding fell secularly from the mid-1980s through the 1990s, to just 53 percent of the total.

**Figure D. Share of budgetary resources in total funding for education**



Source: (1) 1986-1989, calculated according to data provided in China Education Finance Statistics Document 1978-1990, MOE.  
 (2) 1990-1995, from 1997 Annual Report of National Education Finance Development, MOE Finance Department and Shanghai Intelligence Institute.  
 (3) 1996-2002, from China Education Finance Statistics Yearbook, 1997, 1998, 1999, 2000, 2001, 2002.

Today all PSUs (see Box A) are only partially funded by the budget. On average, budget allocations account for roughly one-half of the total funding of PSUs, and they raise the other half from fees and “other incomes.”<sup>21</sup> The budgetary portion varies across sectors and types of institution, though none is 100 percent budget-financed, not even the police or fire departments.<sup>22</sup> For health institutions, nationwide, in 1998 government subsidies covered only 8 percent of operating

<sup>21</sup> For details, see World Bank (2005).

<sup>22</sup> In a 2005 paper, Bai Nansheng detailed how local police departments typically receive only budgetary support for salaries, but have to buy their uniforms, batons and other equipment from own

revenues for public hospitals. The rest came from user charges and drug revenues. Even for public health institutions such as epidemic prevention stations (later renamed centers for disease control) and maternal child health centers, in the late 1990s government appropriations covered only 40, and 30 percent of operating revenues, respectively (World Bank 2002, Table 7.8). Passing along costs to users and charging for services is so universal that in a 2004 field visit to one of China's poorest villages in the Southwest, I was astonished to find that not a single public service was offered free of charge to the residents, not schooling, health care, or even police services (World Bank 2004).

**Box A. China's public service units (PSUs)<sup>23</sup>**

The vast majority of public services in China are provided by PSUs, public entities that are attached to government at various levels. They include schools, agro-technical extension stations, cultural centers, health clinics, and hospitals, etc. Budgetary support for public services is channeled almost exclusively to PSUs. Because of the prohibition of private providers and NGOs until very recently, PSUs are monopoly providers in many services including education, hospitals, and agricultural services.

**4. The Long Term Legacies**

The long period of fiscal decline had forced many adjustments on China's public finances, some with long-lasting and negative effects. In this section I discuss four of the most salient: a) the large fiscal disparities across localities, b) the breakdown of the intergovernmental fiscal system, c) the growth of extrabudgetary activities, and d) the commercialization of the public sector.

**A. Growing disparities across regions**

Over the past quarter century, China's economic growth has been regionally unbalanced, with much higher growth rates in the coastal provinces than in inland

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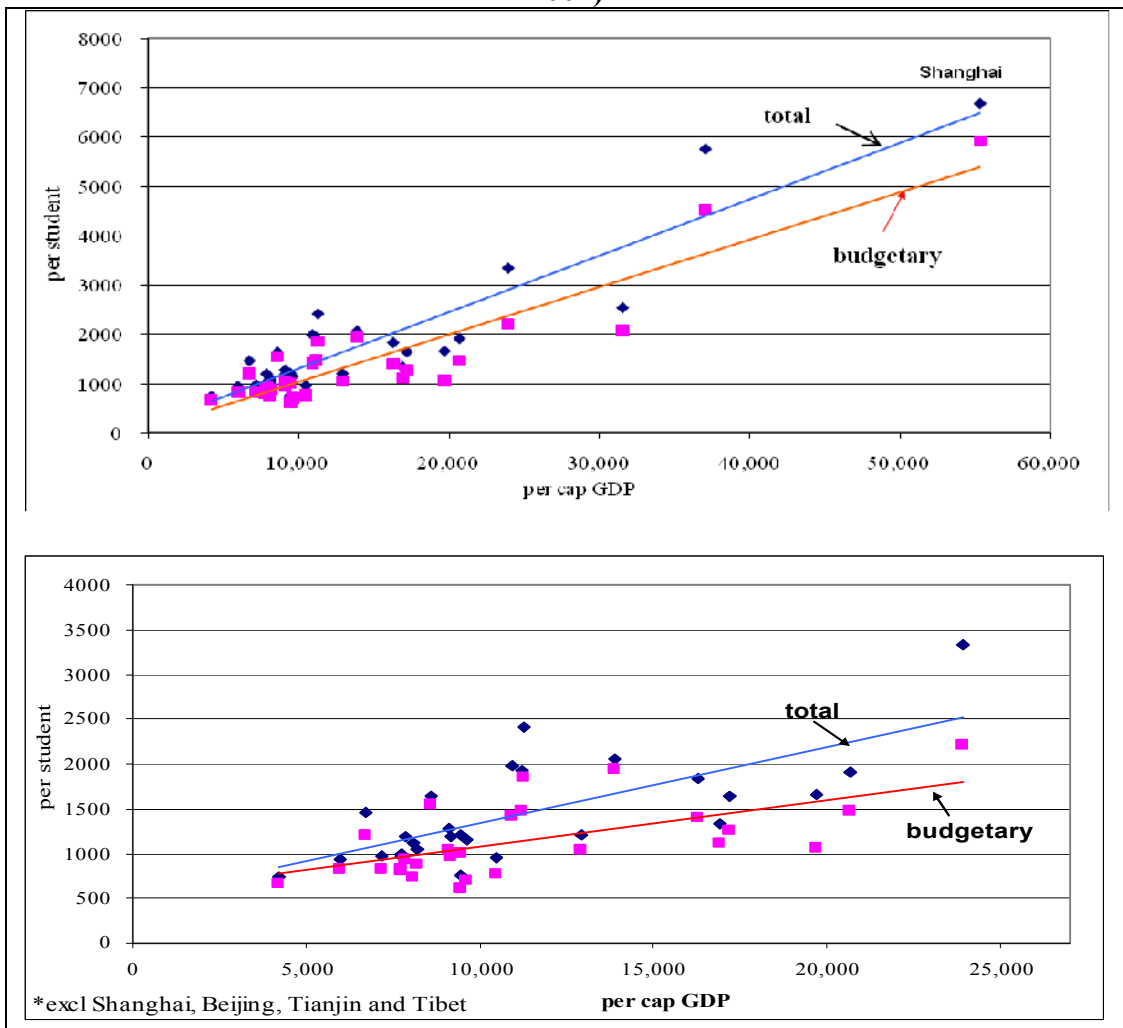
revenues collected through fines and penalties (Bai 2004).

provinces. This, by itself, would have expanded the already large income differences among provinces. The disparities grew worse with the collapse of transfers in the 1980s and 1990s, as the government abrogated its vital responsibility in redistributing incomes. As a result, especially after the shift to TSS in 1994, the distribution of fiscal resources increasingly followed that of regional incomes. Through the 1990s disparities in fiscal resources grew across provinces, and these differences were transmitted directly to spending on social services (Wong 2007, 2008). Citizens in rich localities enjoyed more and higher quality services, while those in poor regions faced low quality services, and often went without. To illustrate, data in Figure E show that in 2004, Shanghai spent ¥ 6700 per student in primary school, nearly 6000 of it from budgetary appropriations. At the low end, the poorest province, Guizhou, spent only ¥ 745 per student, of which 670 came from the budget – about one-ninth as much as Shanghai. Even when the three provincial-level municipalities are excluded, Figure F shows the richest province – Zhejiang, spending ¥ 3300, still 4.5 times the Guizhou level, and 3.3 times its budgetary expenditure per student. These disparities are unusually large, especially considering that they represent *average* figures for very large units, as provinces in China have on average more than 45 million inhabitants, and the largest have nearly 100 million. Data is not publicly available at the county level to do a comparable analysis. In field work conducted in Liaoning province, a World Bank team found even larger disparities. In 2003, on average counties spent ¥ 1,229 per student, but the range was from ¥ 182 to ¥ 2,556 among the 40 county level units (World Bank 2006).

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<sup>23</sup> The State Council (1998) decree on PSU registration defined a PSU as a “social service organization established by the state for the purpose of social public benefit.”

**Figures E and F. Per student expenditure in primary schools, by province (¥, 2004)**



## B. Breakdown of the intergovernmental fiscal system

In China fiscal decentralization goes below the provinces downward to all levels of the five-level system of government, with each level of local government assigned important roles in service delivery. In 2004, governments at the county and township levels together accounted for nearly one-third of national budgetary expenditures, and municipalities accounted for nearly one-quarter. The high expenditure shares of these sub-provincial governments are due to the important and costly functions for which they are assigned responsibility – basic education, health care and social security. For example, because of the large numbers of students, the

provision of basic education is costly, and explains why the county and township governments (responsible for education in grades 1-9) account for 60 percent of the national budgetary outlays for education. Table 2 shows the high shares of subnational governments in the major social expenditures.

**Table 2. Distribution of budgetary expenditures by level of government (2004)**

	Budgetary Expenditures	Education	Health	Social Welfare and Relief
Central	28%	7%	3%	0.7%
Province	19%	15%	22%	9.5%
Municipalities	22%	18%	31%	26.6%
County + Township	31%	61%	44%	64%

In Wong (2007), I called the intergovernmental system “broken”, by which I meant it is not able to support national policy implementation: the Chinese system depends on local governments to implement social policies, but lacks mechanisms for ensuring that they have adequate financial resources to carry out their assigned functions. Through the transition period, the piecemeal, incremental reforms had steadily chipped away the coherence of the intergovernmental fiscal system, and the recentralization of revenues under the TSS reform in 1994 greatly exacerbated the mismatch between revenue- and expenditure-assignments. This is shown in Table 3, where, in 1998 counties and townships had a combined 20 percent of total revenues but 28 percent of expenditures. Although the gap was met by transfers, the unequal distribution of transfers had left poor localities with little assistance (World Bank 2002, Wong 2007).

**Table 3. Fiscal trends for government, by level**

<b>I. Revenues</b>	<b>1993</b>	<b>1998</b>	<b>2004</b>
Central Government	22%	49.5%	54.9%
Provinces	13%	10.5%	11.2%
Municipalities	34%	19.7%	16.6%
Counties	19%	11.5%	12.0%

Townships	13%	8.8%	5.2%
<b>II. Expenditures</b>			
Central Government	34%	28.9%	27.7%
Provinces	11%	18.8%	18.7%
Municipalities	29%	24.1%	22.2%
Counties	16%	19.9%	25.2%
Townships	11%	8.3%	6.1%

Sources: Wong (1997), World Bank (2002), MOF Compendium of Local Fiscal Statistics, various years.

Moreover, the intergovernmental fiscal system has been characterized by distrust and mutual blame. Earlier I pointed to the central government’s distrust of local governments to implement tax policy. During the long fiscal decline, local officials often complained of higher level governments “grabbing” revenues and “pushing down” expenditures. Data in Table 3 offers evidence in support of the local government complaints: while revenues were increasingly concentrated at higher levels, expenditures were going in the opposite direction. The growing vertical imbalances suggest that rural governments (i.e., counties and townships), which are located at the lowest levels of the administrative hierarchy, were especially disadvantaged in their struggle for resources. This was a major cause of the glaring urban-rural inequalities that exist in China today.

As the system of redistribution withered and then collapsed, localities in the lower half of the income spectrum (where virtually all rural local governments are situated) were in chronic deficit. A growing number of them defaulted on their responsibilities and were unable to provide services mandated by law/regulation. As a result, the intergovernmental system became increasingly a bottleneck to policy implementation—with local funding problems limiting services, the government has been unable to deliver on some priority programs such as universal basic education (Wong *passim*, World Bank 2002).

### C. The rise of extrabudgetary activities

Another aspect of the breakdown of the intergovernmental fiscal system is the growth of off-budget financing of government, especially at the local levels (Wong 1998, Fan 1998, and Wong and Bird 2008). The rapid growth of extra-budgetary funds during the 1990s was also linked to the fiscal decline and especially the recentralization of revenues under the TSS – allowing local governments to tap off-budget revenues was driven by the need to enable local governments to carry out their assigned functions. In the aggregate, in the late 1990s off-budget resources used by government and public agencies may have amounted to as much as 19-27 percent of GDP (in addition to the formal budget).<sup>24</sup> Reforms in the past few years have abolished many fees and levies – including, most famously, all rural levies under the Rural Fee Reform; others have been brought into the budget.<sup>25</sup> As fees and levies are abolished, however, local governments have grown increasingly dependent on revenues from land development, and these revenues are reported in neither budgetary nor extrabudgetary accounts. Since off budget resources are generally more plentiful in rich regions than poor ones, be they “management fees” collected on gross turnover or on profits, land sales and revenues from user charges, this reliance on off-budget finance probably exacerbates regional disparities since, unlike budgetary revenues, they are not subject to redistribution through the intergovernmental fiscal system.

While the extra budgetary revenues had undoubtedly played a positive role in aiding the provision of services during the period of fiscal decline, they also opened a “back door” financing channel outside the purview of the Ministry of Finance, providing local governments -- especially in rich regions, with real autonomy. This

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<sup>24</sup> The nature and size of extrabudgetary funds are explored in Wong (2001).



too has contributed to “breaking” the intergovernmental fiscal system by weakening the central government’s ability to affect fiscal outcomes.

#### **D. Commercialization of the public sector**

Through the 1980s and 1990s, the financing of public services was increasingly privatized, with an increasing share of the costs passed through to citizens and users. This applied to government bodies as well as PSUs, as they too came to rely increasingly on extra-budgetary resources.

While the original impetus for user charging and seeking other revenues came from budgetary shortfalls, their continuation into the 21st Century appears to be driven increasingly by the self-interests of the PSUs and government agencies. Strong evidence for this was found in a 2005 World Bank study in which I participated (World Bank 2005). First, we found that despite large additional injections of funds by the government in recent years, the collection of fees and other incomes continued apace. For the 2000-2002 period, for example, budget appropriations rose from RMB 362 billion to 659 billion, an increase of 82 percent, and raising budgetary spending on PSUs from 4.1 to 6.4 percent of GDP.<sup>26</sup> However, during the same period self-raised revenues of PSUs grew 43 percent and “service revenues” by 53 percent. As a result, the overall proportion of budgetary finance in PSUs rose only from 42 to 48 percent; in the key sectors of education and health the effect was even smaller. Moreover, the additional budgetary inputs were more than wholly absorbed by personnel expenditures, which increased by 91 percent, due to a combination of higher salaries and increased employment. The outcome was that the additional injections had little effect on reducing user fees except in a few

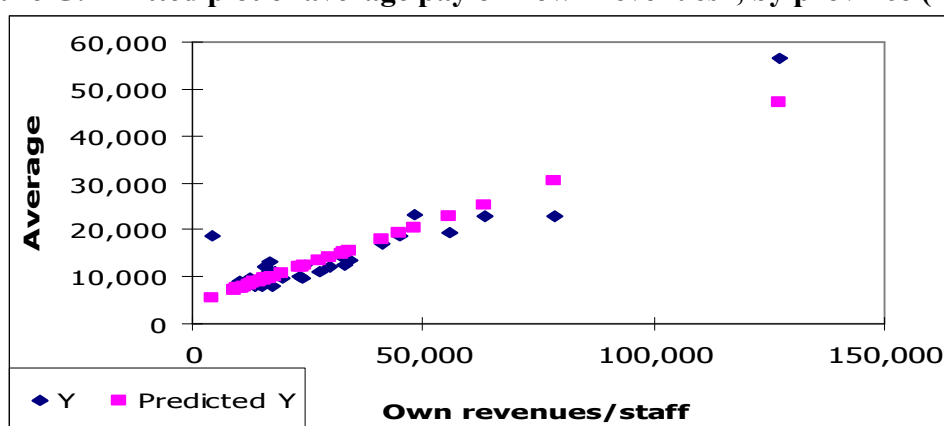
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<sup>25</sup> Reported extrabudgetary revenues have fallen to just 3.4 percent of GDP in 2003.

sectors where administrative measures were imposed.

In fact, in regression analysis on PSUs by sector, by province, and by tier of government, we found that budgetary inputs (on a per employee basis) were correlated neither with the share of budgetary inputs nor with total inputs. Instead, a very strong correlation was found between nonbudgetary revenues (i.e., fees and other incomes) and average salaries. That is, PSUs that collected more “own revenues” paid higher salaries than those collecting less.<sup>27</sup> The tight linkage between own revenues and staff remuneration is shown in Figure G.

**Figure G. Fitted plot of average pay on “own revenues”, by province (2002)**



Source: World Bank (2005), Figure 1.5.

Needless to say, these are powerful incentives for PSUs to seek own revenues. These incentives were created when the budget was providing declining support to the PSUs, and a reform was implemented to “push PSUs into the market.” This reform gave PSUs greater managerial autonomy to expand the scope of services and permitted them to link managerial and staff remuneration to the revenues they raised. These concessions were made at a time when civil service salaries were low and there was widespread acceptance of the need to raise them. Over time, however, “topping up salaries” has become institutionalized and built into the remuneration structure. As illustration, a “performance-based” remuneration system for doctors in a Chinese traditional medical hospital is presented in Box B. Table 4 shows that nationwide, in 2002 the “basic wage” – i.e. that stipulated by the civil service pay scale, accounted

<sup>26</sup> Since this was a period of mild deflation, these increases are approximately in real terms.

<sup>27</sup> The coefficient is 0.34, and the R-square is 0.84.

for only a little more than half of take-home pay for public employees. The rest was made up of “bonuses and subsidies” financed mostly from own revenues.

**Box B. Performance-based remuneration in a hospital**

A local newspaper reported that a Chinese traditional medicine hospital implemented a new compensation system focusing on performance in 2003. Under this new system, doctors receive on average 30 percent of their regular salary as base pay. The remainder is made flexible and dependent on “performance”. A doctor in a “poorly performing” department receives RMB700 per month while those in “better performing” departments may earn as much as RMB10,000. The best performing department turns out to be “Department of Occupational Injury Verification”. Doctors also get a part of their pay based on the value of drugs and services they prescribe. For example, a doctor receives 11 percent of the value of Chinese herbal medicines, 2 percent for western medicines, 10 percent for chemical and physical tests, 13 percent for injections, RMB17 for each CT test, and RMB10 for each Ultra Sound test.

Source: Local newspaper report. See <http://news.sina.com.cn/c/2004-06-07/01593389284.shtml>. Cited in World Bank 2005.

**Table 4. Composition of remuneration of PSU employees, 2002.**

	Total pay (yuan p.a.)	Basic wage	Bonuses and subsidies	Share of basic wage in total	Memo item: share of PSU funding from budget
National average	11,045	6,238	4,807	57%	48%
By tier:					
Central	15,001	6,151	8,850	41%	49%
Provincial	13,199	6,320	6,879	48%	44%
Prefectural	13,604	6,951	6,653	51%	38%
County	9,508	6,030	3,478	63%	53%
Township	10,157	6,430	3,727	63%	60%

Source: World Bank (2005), Table 1.2.

By “commercialization of the public sector”, I refer to the (own) revenue-seeking orientation of PSUs and government agencies alike, all of which are doing whatever they can to earn money. Not only do museums rent out space to advertising and product displays, libraries set up photocopying centers and even pinball parlors, and the like, but that public health institutions such as the centers for disease control and maternal child health stations are also vying to provide fee-paying services to augment salaries. Following the Cultural Revolution legacy of educating students through hands-on labor, schools set up factories and workshops to earn extra

income, and were given tax exemptions as added incentives. In 2002, these workshops and factories earned RMB 5.4 billion to contribute toward financing education (Yearbook of Education Finance Statistics).<sup>28</sup>

Revenue-seeking behavior is not confined to PSUs, but characterizes government agencies at the central and local levels as well, and it is driven by the same incentives. In the 1990s all government agencies created money-making entities – development companies, tourism “spots”, and the like.<sup>29</sup> Central ministries, too, were adding money-making activities to their portfolios –the Ministry of Finance had an investment trust company, the then-State Planning Commission established the New China Airlines, and the then-State Statistical Bureau had a for-profit Information Center that sold data and provided data processing services. Virtually all ministries created new journals, magazines and yearbooks, for which subscription was often mandatory for subordinate units. In recent years these activities have been reduced at the central level after several rounds of clean-up campaigns, but many continue apace at the local levels, and continue to support bonuses and welfare benefits (including housing) to their staff members.

## **5. Conclusions**

After three decades of spectacular economic successes, China is facing significant challenges in strengthening its government apparatus to manage the increasingly decentralized, complex economy. The string of recent scandals – environmental degradation, lapses in public health, violations of safety standards, the

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<sup>28</sup> The tragic story of an explosion in a rural primary school in Jiangxi that killed four teachers and more than 36 children in March 2001, was likely the result of this practice – reports of the accident indicated that parents had long complained that the school was using students to assemble fireworks for sale (China News online, March 7, 2001).

<sup>29</sup> One official in a medium sized city in the Southwest told me it began in the early 1990s, when Deng Xiaoping’s “southern tour” seemed to open the door to all entrepreneurial activities within and outside government (field visit in February 1998).

prevalence of fake drugs and chemicals, have all pointed to the government's weaknesses in protecting public safety, exposing an enormous gap between China's growing economic prowess and its capacity to govern.

Are these "growing pains" of China's extremely rapid economic transformation and integration into the global economy? With the leadership now focused on the need to improve its regulatory regime, will China finally "catch up" and build the public institutions necessary to govern a modern economy? The analysis I have presented in this paper leads me to a pessimistic view.

In this paper, I have argued that the roots of the current problems of weak governance, regulatory failures and growing inequality can be traced to the retrenchment of government in the 1980s and 1990s, and the incremental approach adopted. The ad hoc devolution of authorities and lax oversight have produced large distortions in the incentive structure facing governments and public institutions. At present, the capacity of the central government to direct economic and social change is constrained by: 1) the large regional disparities in economic development and human capital capacity, 2) a broken intergovernmental fiscal system that is unable to support national policy implementation, 3) accountability mechanisms that have been severely eroded by long periods of inadequate finance, so that local governments and public institutions could not be held accountable for results; 4) an information system that is very weak from disuse; 5) a bloated bureaucracy where authorities are fragmented, where the transmission of policies and resources are complex and unreliable (World Bank 2007). Most of all, government is hobbled – throughout the whole administrative apparatus, by agents whose (own) revenue-hunger dominates decision-making.

In the first decade of the 21<sup>st</sup> Century, the constraints in China to improving

public services and consumer and environmental protection are, unlike the previous two decades, no longer the shortage of money. Instead, the main problem is how to mobilize government agencies and public institutions to implement national policies and enforce existing laws and regulations. Since 2000, the government has implemented numerous programs of public sector reform – budget reform, treasury reform, procurement reform, streamlining of rural government, etc. These have brought some improvements and made government more transparent. The recent programs of free rural education, rural cooperative medical schemes, minimum living stipends (低保), etc., are transferring substantial new resources to funding services at the grassroots levels and improving fairness. However, until the incentive structure for government agencies and public institutions is fundamentally altered, these top-down, incremental reforms of the public sector will likely have only limited effect.

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