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China – Masterclass: What makes 40 million local government officials tick?

- The way local officials are managed has been key to China’s growth for decades; now it needs to change
- Officials are incentivised to hit economic targets, but are not punished for failing
- Fiscal revenues, education and friends in high places help with promotion prospects
- The performance assessment system incentivises wasteful investment and high land prices; a new, results-based system is needed to help change the growth model

A few weeks ago, we found ourselves in the countryside of Hong’an, two hours’ drive north of Wuhan in central China. Standard Chartered helped to organise a training programme there for a group of local county government officials at the Hubei Party School. Hong’an is an old revolutionary base and the birthplace of Li Xiannian, a former Red Army general and president of China who helped bring about the downfall of the Gang of Four in 1976. There is a museum there, a miniature version of the offices of Zhongnanhai, with a film about Li’s life. We are told that when he was managing China’s economic and fiscal affairs, he warned his children that he would break their legs if they went into business (none of them did, apparently).

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We tell of our travels because the officials we met are on the frontlines of government policy and economic growth in China. They are selling land and dealing with excess housing inventories; they are lobbying their government superiors for project funds and seeking private investors; they are solving myriad day-to-day disputes that their supervisors never have to bother with. Talking to them brought us back to a question we have been pondering a lot recently: What exactly motivates officials in China today? Every country has local government officials, but in China, the extensive powers of the state and the government’s intimate role in business make them especially important to understanding the economy. If you want to understand how a hive works, start with the bees.

For this reason, today’s Masterclass note explores the incentives driving local officials, and how those incentives might be changed. The performance assessment system run from Beijing and the provincial capitals is an important driver of these incentives. Officials should be motivated to do what it takes to get promoted. However, we find that the standard answer to what gets you promoted – delivering economic growth, which is the most important part of the performance assessment – is not quite accurate. There are many other considerations that drive ambitious local officials: fiscal revenues, other payments, relations with seniors, construction projects. So, if we want to understand what drives local officials’ behaviour, we need to look beyond the assessment system. We will also show that the current assessment system – and broader set of incentives – produces bad outcomes (hidden public debts, wasteful investments and high property prices), perhaps increasingly so. Only when we understand what really motivates local officials can we consider how to change their behaviour. We explore ideas on how to do that at the end of this note. If China is to move towards a new growth model, then incentives driving officials’ behaviour will need to change.



To address these questions, we dig into the work of Pierre Landry, Victor Shih, Lynette Ong, Graeme Smith, Wu Jing, James Kung and Alex Wang, all members of the A-team of political economists currently working on China.

For some, the system works, and works well

Some analysts believe the performance system works well

Some of these analysts believe the performance system works well: It not only sets the right priorities to achieve economic growth and maintain stability, but it also successfully incentivises that behaviour in local officials.

Pierre Landry at the University of Pittsburgh notes that power in one-party states is usually heavily centralised (*Decentralised Authoritarianism in China*, Cambridge University Press, 2012). This is because decentralised power is usually dangerous for such a ruling party. Given half a chance, local governments refuse to implement orders, nurture their own ambitions and build their own power centres. Decentralising power at the same time as unleashing market reform – as China has done since the 1970s – doubles down on those risks. With growth, potential local opponents suddenly have the resources they need to oppose the centre’s bosses, or at the very least ignore them.

Mikhail Gorbachev’s Union of Soviet Socialist Republics (USSR), for instance, disintegrated after Moscow decided to reform in the late 1980s. While some local leaders decided to take on Moscow politically, most others saw their power and their ability to make a quick buck disappear, and went off to do something else. Steven Solnick has written brilliantly about such mass defection (*Stealing the State*, Harvard University Press, 1998). The point has pedigree: Alexis De Tocqueville, a popular read among China’s Party leaders these days, famously made the point that revolutions take place just at the moment when a regime, recognising that its model is unsustainable, begins to reform (*The Old Regime and the Revolution*). All of a sudden, the people can see a brighter future without the old bosses, and are willing to push the envelope to get there.

China has defied this pattern. Thirty-five years since economic reforms ripped through the calcified heart of the centralised Maoist model, decentralising power on a mass scale, the Chinese Communist Party (CCP) remains firmly in charge, basically unified and managing a much wealthier, stronger country. How does the CCP do it?

The performance assessment system is one of the main glues that keep Party officials unified around key objectives

Prof. Landry argues that the ‘secret sauce’ is the Party’s successful system for managing its officials. The CCP’s Organisation Department (OD) is the nerve centre for cadre appointments and performance assessments. Landry explains that in the 1980s, the OD centralised power, determining all Party and government appointments ‘two levels down’. In other words, the central OD appointed Party Secretaries in the provinces and Party functionaries at the level below that, in the towns and counties. This, however, turned out to be too much work for the OD – particularly at a time when Beijing was occupied rehabilitating tens of thousands of officials (including a certain Comrade Xi Jinping) who had been sent down to the countryside or otherwise ill treated during the chaos of the late 1960s and early 1970s.

In 1984, a new ‘one-level-down’ system was introduced, giving the OD headquarters in Beijing direct control over about 4,200 senior appointments and allowing provincial-level ODs to appoint officials at the level below them. (The leaders of these local OD offices are appointed by local leaders in negotiation with Beijing.) The



county, in turn, appoints township officials. This 'one-level-down' system has endured until today – and it explains why the bureaucracy has held together so well. It has ensured that at the end of the day, local officials will act to support the central government's and their direct superiors' basic goals.

Economic reform involved the devolution of economic decision-making power to the localities; this promoted growth, but without the performance assessment system, it may have resulted in chaos

Economic reform policy during the 1980s and early 1990s can be broadly summed up by one instruction to the localities, particularly the cities: Get on with it. Cities were allowed to set up and run Special Economic Zones with different legal, price and tax structures; township officials threw themselves into attracting investment, offering free land to manufacturers and running their own businesses; local taxes became negotiable; Shanghai and Shenzhen set up stock exchanges, and so on. At the height of reform, how did the system hold together?

The central government's performance metrics are the main tool by which it successfully manages its employees. Since the early 1980s, local officials have been assessed on the basis of scores across a variety of economic, social and political variables. Such performance targets (*kaohé zhibiao*) are normally scored on a scale of 100 and are ranked in three tiers:

1. 'Veto' targets (*yipiao foujue*). These include social stability and birth rates. Failure to meet these targets leads to fines, sackings, demotions or heavily reduced chances of promotion.
2. 'Hard' targets (*ying zhibiao*). These include economic growth, investment and fiscal revenues. They score highly and pay bonuses.
3. 'Soft' targets (*yiban zhibiao*). These include education and health, cultural activities, and pension coverage. Meeting these targets wins only a small number of points.

It is up to local governments to set their own detailed performance targets, though most look similar.

Every year, these targets are combined with 'democratic appraisals' – performance feedback from one's peers and juniors – and are used to help determine promotions. Landry has collected performance data for mayors in 104 cities in 2000 (Figure 1). The mean score was 64 out of 100, with a standard deviation of 11. Per-capita GDP growth was the most important benchmark, a category in which one could score up to eight points. (Note that 'jobs created' does not appear anywhere here, despite conventional wisdom that the government is interested in creating jobs; we will return to this paradox later.) Landry also has data on where these mayors went when their average 2.5-year term ended.



Figure 1: Municipal performance indicators of 104 cities (2000)

	Indicator	Target	Weight (points)	Mean	S.D.	Min.	Max.
Economic development (28 points)	GDP per capita (US dollars)	5,000 and over	8	2.59	1.66	0.46	8.00
	Share of non-agricultural sectors in GDP (%)	90 and over	4	3.74	0.43	2.15	4.00
	Share of services in GDP (%)	55 and over	4	2.97	0.68	1.13	4.00
	Contribution of technical progress to GDP (%)	50 and over	4	3.29	0.69	0.40	4.00
	Imports + exports/GDP	45 and over	4	1.43	1.30	0.00	4.00
	Degree of urbanisation (%)	60 and over	4	2.81	1.15	0.46	4.00
				16.10	3.89	5.86	27.06
Human capital (17 points)	Literacy rate among people age 15 and above (%)	95 and over	3	2.95	0.15	1.85	3.00
	Proportion of the population with vocational college education and above (%)	10 and over	3	2.06	0.94	0.01	3.00
	Educational expenditure as % of GDP	5 and over	3	1.09	0.69	0.01	3.00
	Average life expectancy (years)	75 and over	4	3.87	0.13	3.47	4.00
	Reduction in natural growth rate of the population (per thousand)	5 and over	2	1.63	0.44	0.52	2.00
	Death rate during delivery (per thousand)	10 and over	2	1.67	0.49	0.46	3.00
				12.07	3.19	1.37	16.96
Quality of life (22 points)	Engel's Index	30 and over	4	3.13	0.42	1.71	4.00
	Available housing space per capita (m ²)	18 and over	2	1.68	0.38	0.79	3.16
	Electricity use per capita (kilowatts per hours)	600 and over	2	1.03	0.56	0.20	3.00
	Phone penetration per 100 people (units)	50 and over	2	1.33	0.58	0.18	2.00
	Home computer utilisation ration (%)	20 and over	2	0.84	0.60	0.00	2.00
	Number of commercial points (per 10,000 people)	100 and over	2	1.78	0.42	0.44	2.00
	Number of financial points (per 10,000 people)	10 and over	2	0.94	0.49	0.09	2.00
	Number of libraries, museums, and theatres (per 10,000 people)	1 and over	2	0.81	0.66	0.06	2.00
	Number of doctors' visits (per 10,000 people)	50 and over	2	1.24	0.57	0.01	2.52
	Number of criminal cases (per 10,000 people)	15 and over	2	1.21	0.70	0.18	2.01
				13.22	2.86	2.72	21.87
Environmental protection (18 points)	Coverage of green areas	35 and over	3	2.38	0.75	0.09	3.00
	Availability of public green space per capita (m ²)	10 and over	3	1.94	0.77	0.28	3.00
	Treatment of used industrial water (%)	90 and over	3	2.63	0.61	0.20	3.00
	Treatment of used household water (%)	60 and over	3	1.86	0.93	0.04	3.00
	Handling of garbage (%)	80 and over	3	2.54	0.79	0.13	3.00
	Air pollution level (grade)	Second Grade and below	3	2.76	0.44	1.50	3.00
				13.02	3.10	2.34	18.00
Key Infrastructure (15 points)	Availability of paved roads per capita (m ²)	10 and over	3	2.24	0.73	0.36	3.00
	Utilisation of motorised vehicles (per 10,000 people)	1,000 and over	3	1.66	0.97	0.02	3.00
	Availability of running water (%)	100	3	2.82	0.46	0.81	3.00
	Consumption rate of natural gas (%)	100	3	2.45	0.65	0.37	3.00
	Number of domestic and international air routes	30 and over	3	1.89	1.18	0.10	3.00
				10.03	2.34	3.98	15.00

Sources: Pierre Landry, compiled from CUDRC, China Urban Yearbook 2001



So, what determines career success? The orthodox answer is avoiding social instability and successfully promoting economic growth. This is the finding of Chen Ye, Li Hongbin and Zhou Li'an ('Relative performance and the turnover of provincial leaders in China', 2005). They looked at 344 provincial leaders from 1979-2002 and found that economic success is rewarded, especially if you achieve more growth than your predecessor (performance relative to officials in neighbouring districts did not matter so much in their study).

There is a virtuous circle of economic growth – rising land prices and being promoted – which is one of the keys to understanding China

More recently, Wu Jing at Qinghua University and colleagues studied 283 city-level government and party officials during the 2000-09 period and looked at the relationship between land sales, transport and investment in environmental protection (almost all of which are financed locally), economic growth and officials' career paths ('Incentives and outcomes in China's environmental policy', NBER Working Paper 18754, 2013, with Deng Yongheng, Huang Jun, Randall Morck and Bernard Yeung). They show that promotions are linked to a circle of urban development, characterised as follows:

- Higher land sales in one year are correlated with higher transport infrastructure investment in following years, but not with environmental investment.
- Higher levels of transport investment in one year are correlated with faster economic growth in following years. Environmental investment is not correlated with future growth.
- Higher levels of transport investment in year one are correlated with higher land prices in following years.

So higher land sales allow for more transport investment, which then delivers faster growth, which in turn makes land more valuable, which raises land-sale revenues, and so on. Accelerating this process ultimately gets you promoted. The authors found that an official's GDP growth performance relative to his predecessor's was the critical factor in winning a promotion (as in the study above). An improvement of one standard deviation in performance raised mayors' promotion chances by 10 percentage points. So Prof. Wu and colleagues believe that the driving force behind this circle of land-investment-growth is officials' desire to get promoted.

Strong economic performance may not get you promoted; weak economic performance rarely gets you sacked

Landry finds that the best economic performers are indeed much more likely to get an 'external' promotion – a job in a different location or a different part of the bureaucracy. However, he also finds that poor performance is not punished; demotions and sackings are uncorrelated with a poor score. In fact, poor performers end up staying in mayoral positions longer, he finds. This may seem irrational and look like evidence of a breakdown in the system, but Landry argues that it makes sense in terms of stability. This way, he argues, one limits 'defections' among those who might otherwise lose out, and the lack of large-scale sackings contains factional infighting within the Party. Moreover, the rigorously enforced retirement age (60 for men, 55 for women) means that unproductive officials are put out to pasture anyway.

Landry compares today's CCP favourably with the party in the USSR under Mikhail Gorbachev (and Nikita Khrushchev), where large numbers of elite sackings and defections destabilised the system and eventually brought its collapse. He also shows that China's bureaucracy today is being rejuvenated by younger, better-educated and more specialised officials (like some of the ones we met in Hong'an), a key objective of the central government.



Landry is an optimist. He thinks the system works: Officials are incentivised by the performance system to promote growth, and this growth benefits the country and the Party. While localities may do their own thing sometimes, and their implementation of many policies and regulations is poor, officials do not stray too far from the important targets. As the ancient saying goes: The mountains are high, and the emperor is far away, but he can still send down the Central Discipline and Inspection Commission if you do not ultimately do as you are told.

The view that the system does not work so well

Others see a system malfunctioning in several ways:

Other scholars believe that the performance assessment system is dysfunctional in important ways

- Promotions are based more on patronage than economic performance, some have found, ultimately leading to political instability.
- Economic performance incentives generate bad outcomes like hidden debt, high property prices and the loss of agricultural land.
- The importance of performance assessments is overwhelmed in practice by monetary payments, one academic has found.
- Performance assessments bias behaviour in the wrong ways, for instance by diverting resources from important activities.

Below, we look at each of these problems in turn.

Patronage over economic performance

Victor Shih, currently on leave from the University of California, and colleagues have looked at senior-level Party promotions of Central Committee officials working in the provinces from 1982-2002 ('Getting ahead in the Communist Party', *American Political Science Review*, February 2012, with Christopher Adolph and Liu Minxing). Applying the most sophisticated statistical model yet to this question, they found no correlation between promotions and economic performance. Instead, they found that education helped get one promoted, as did raising fiscal revenues and having ties to more senior officials (though these effects varied over the course of the period studied and were sometimes weak).

When you fill a senior position, it is likely that economic performance becomes a less important factor for career progression

Education helped, the authors argue, as the regime sought talent to fill its upper echelons – a shift from the emphasis on ideological purity in earlier years. The ability to generate fiscal revenues became particularly important after 1994, as Beijing wanted to raise revenues after coming close to fiscal collapse earlier in the decade. But GDP growth did not improve promotion prospects: "Given our findings", Shih and colleagues write, "one can no longer argue that China enjoyed spectacular growth because of [GDP growth] promotion incentives". Since their study looks only at the movement of elite Central Committee members, they also point to Landry's finding that local economic growth has no impact on the most common promotion move for a mayor – the move to become Party Secretary of the same city. They then turn Landry's logic partly on its head: The fact that failure is not punished, they argue, does not reflect a system nurturing stability but an environment of patronage that rewards loyalty over competence. Such a system, they argue, is intrinsically unstable.



Assessments lead to debt, high house prices and wasted land

There is other evidence of a malfunctioning system. Based on an in-depth study in four rural townships, Lynette Ong at the University of Toronto shows how performance criteria can create an economic mess (*Prosper or perish: Credit and fiscal systems in rural China*, Cornell University Press, 2012). She shows that all local officials are incentivised to grow – i.e., industrialise – their local economies, whatever the initial conditions. Some townships grow, but others – those that are unsuited to industrialisation – do not and instead get mired in debt.

Even if local conditions support going into, say, textile manufacturing, it is highly unlikely that all the counties in the same area will be successful. Everyone rushes in anyway; officials who succeed are showered with praise (and possibly promotions); those who fail see their townships loaded with debt, which is then passed on to their successors. Thanks to such dynamics, local government debt was estimated at CNY 4tn (13% of 2008 GDP) even before the CNY 4tn stimulus package of 2008-10, according to researchers connected with the Ministry of Finance (*On the Ground, October 9, 2008, 'China – Masterclass: Meanwhile, down in the villages, Part II'*).

Often, economic growth has nothing to do with the quality or policies of local officials; it may just be a geographical factor

The determining factor for economic failure or success, Ong shows, is an area's distance from a major city – the source of competent managers as well as infrastructure, a supply chain and a market. Officials' performance therefore depends on whether they are sent to a town near a big city or one out in the sticks. (To be fair, Mr. Fang, a young deputy county chief on a year-long assignment from a Wuhan university, told us in Hong'an that in his experience, local OD officials differentiate between officials sent to booming towns and those sent to remote areas. Officials will often be sent to two different places to test how they do in different environments.)

James Kung at the Hong Kong University of Science and Technology agrees with Victor Shih's view that economic performance is not correlated with promotion prospects. He finds, however, that land sales are important to career advancement ('The mystery of authoritarian growth: Land revenue and the career concerns of China's local leaders', with Chen Ting, 2013). The more money you raise from selling land, the more you have to spend on big infrastructure projects and the bigger the impression you make on your superiors. Kung studied 5,000 county chiefs in 1,664 counties from 1999-2008. He found that a doubling of land revenues increases officials' chances of promotion by some 40%. County chiefs tend to increase their revenues in years 2-4 of their tenure and slow sales in year 5 to ensure that limited funds are left for successors.

High land prices are one of the results of the current system

Moreover, an official who converts more rural land into urban land than he is meant to does not harm his career prospects. In fact, such behaviour is probably preferred by the upwardly mobile, since more funds are available for infrastructure development. This is bad news for the Ministry of Agriculture, which is trying to maintain agricultural land (*On the Ground, 6 March 2013, 'China – A little hope for land reform...in Shenzhen'*). Prof. Kung also finds that personal relationships with one's superiors, which may be smoothed by large-scale land-sale revenues available to spend, are important to career progression. The clear downside of the system, according to his findings, is that officials are clearly incentivised to keep land (and thus property) prices high, and do not use land efficiently. For a leadership again facing rapid property price appreciation, this is a serious downside of the assessment/promotion system.



Monetary payments are often important too

To understand how monetary payments work in practice, we believe the best research is by Graeme Smith, a sociologist at the University of Sydney ('Political machinations in a rural county', *The China Journal*, July 2009). He spent much of 2004-08 working on poverty alleviation projects in a rural county in poor Anhui province – fictitiously named 'Benghai' to protect the innocent, and not-so innocent. As a result of innumerable banquets and other types of socialising, Smith is able to lay out in amazing detail how the county government worked. He argues that county officials do little to implement policy unless three conditions are met:

1. The policy helps with officials' assessment by their superiors (as Pierre Landry has shown).
2. The policy results in higher budget and/or off-budget government revenue (as Victor Shih's work hinted at).
3. There are benefits, usually financial, for the officials involved (such things are almost impossible to research with the use of statistics).

Many local officials are interested in reaching their economic targets, thereby increasing local government and other revenue

Officials, like everyone else, have multiple incentives. Think about all the fancy, large government offices being built all over China. They contribute to GDP, and official revenues are raised through the sale of the land the old government buildings sat on. Smith's logic suggests that such projects could, in theory, also allow for kickbacks via the procurement process.

Even if the assessment system plays a role in determining promotions, Smith found that many local officials are sceptical of it. Apart from those destined for greatness (who are rated 'excellent', or youxiu, for three years running), most are simply 'passed' (hege), he found. Smith tells us that it is quite difficult to fail these assessments, since the assessors would risk starting a fight with the officials' friends. As a result, meetings are held, study visits organised, budgetary funds moved around, boxes ticked, and numbers nudged until everyone's score sheet does not look too bad.

Performance assessment system distorts the whole bureaucracy

More seriously, Smith found that 'hard' targets can distort the effectiveness of the entire bureaucracy. Family planning (i.e., preventing people from having more babies than their quota) is a 'veto' target, so local leaders have an incentive to over-resource in this department. Smith notes that in Benghai, only one-quarter of agricultural technicians were doing their assigned job; another quarter were working for the family planning department, and the rest had been seconded to other priority sectors. Low birth rates are guaranteed – but agricultural productivity and farmers' livelihoods suffer.

Local officials spend a lot of time hosting visiting seniors, and lobbying for funds, and as a result, the quality of local government service suffers

Another source of dysfunction is that one of the main jobs of township officials is to plan, accompany and entertain visiting officials from the county – the people who influence the assessments and control the funds. Zhao Shukai, a sociologist at the State Council's Development Research Centre, found that in the areas he studied, the average township leader spent 100-150 days a year playing host, while entertainment absorbed 5-10% of local fiscal revenues. Township leaders spend much of the rest of their time in the local county seat lobbying their superiors for funds and support. (The county leaders are in turn busy lobbying in the provincial capital, and so on.) The township government that Smith portrays certainly cannot be described as 'service-oriented'. Rather, he argues, it is hollowed out.



Economic growth is probably important for officials working at the grassroots – alongside other factors, of course

So, does growth get you promoted or not?

Whether generating growth in your jurisdiction gets you promoted under the current system is not clear-cut. Chatting with the officials we met in Hubei, the people down in the trenches, we got the clear impression that ensuring economic growth was a big factor in motivating their behaviour. Deng Guosheng at the School of Public Policy and Management at Qinghua University studies officials' performance, and he almost laughed us out of his book-crammed office for suggesting that economic growth was not that important to promotion. "Of course it's important", he said. "You may have friends in high places, but if you do not achieve your growth target, your career is still going to be damaged – and remember, everyone is competing for that promotion."

Guangdong Party Secretary Hu Chunhua was recently quoted calling for Guangdong to do its best to maintain its position as China's largest provincial economy (Jiangsu looks like it might overtake Guangdong soon). That means more investment, Hu said. His predecessor, in contrast, called for more services-sector development, for a government focus on creating a level playing field and removing blockages to business, and for Guangdong to lead the change in China's economic growth model. The sharp shift in rhetoric suggests that Hu still believes GDP is an important factor in being promoted – or at least fears what a bigger Jiangsu could do to discussions about his own performance.

Economic growth is not the only parameter that gets one promoted – but we believe it is important, likely even more so at the lower levels of government. Other factors, such as friends in high places, are important too, and become more important the higher one rises in the bureaucracy. Based on our findings, the performance system is one of the pistons in the engine of China's growth.

Can changing the performance system help to change the growth model?

Even if it promotes growth, the advantages of China's current system for assessing officials are clearly fading over time. The scholars discussed above have clearly laid out its dark side. In sum, we believe that the current system is delaying the transformation of China's economic growth model.

The performance assessment system is skewed towards incentivising fixed asset investment – few officials get rewarded for local service sector growth

The assessment system creates incentives for fixed asset investment, which generates immediate GDP growth and buys the possibility of future fiscal revenues (if revenues do not materialise, the debt will be someone else's problem). This system used to function since manufacturing and construction created jobs – although the assessment framework hardly ever measures jobs, the system did deliver employment by incentivising construction. However, as heavy, capital-intensive industry has developed in the past decade, the number of jobs generated per dollar of investment has fallen. The current assessment system also appears to push up property prices, and undermine the ability of the bureaucracy to become truly service-oriented. If the assessment system continues as is, it will generate ever more capacity, bigger government debts, more land expropriation and angry farmers, higher apartment prices, and less job growth. And the country's shift to a consumption-led growth model will be delayed.



At the margin, in already-industrialised parts of China, the next wave of jobs for school and university graduates will be in services – and the current performance system has a much harder time encouraging government officials to focus on nurturing services. Services do not generate FAI, and they provide fewer opportunities to generate local tax revenues and other payments, partly because they generate fewer large-scale construction projects, and partly because their accounts are easier to massage. Services firms are also much more mobile than manufacturers – and local authorities do not like tax-paying companies to leave their jurisdictions.

So, the question is: Can changing the performance criteria change officials' behaviour – and thus the way China grows? Alex Wang at the University of California's Berkeley Law school believes they can, at least a bit. He has looked at the impact of the environmental targets introduced in 2005 under the 11th Five Year Plan ('The search for sustainable legitimacy: Environmental law and bureaucracy in China', *Harvard Environmental Law Review*, to be published in 2013). Until then, environmental targets had been widely ignored, but when 8 of the 22 targets were made 'hard' targets – including 10% emissions reduction targets for sulphur dioxide and COD (chemical oxygen demand), and a 20% reduction in energy efficiency – officials were seriously incentivised, he found. Provincial leaders set and shared targets for their towns and counties, which were then incorporated into individual performance targets. State-owned enterprises did the same for their subsidiaries. These targets were expanded under the current 12th Five Year Plan (FYP) to cover carbon intensity, renewable energy, and other areas.

Environmental targets were taken more seriously once they were made 'hard' targets, but local officials were most keen to invest to meet them, rather than implement fines or serious monitoring

The central government laid out three approaches to meeting the 11th FYP environmental targets:

1. New investment in emissions and waste reduction equipment
2. Closure of polluting capacity, ranging from coal-burning power plants to steel and aluminium smelters
3. Stricter monitoring of local factories and significant fines for polluters

Unsurprisingly, localities were keenest on the first, pro-growth approach. The proportion of cities with waste-water treatment rose from 25% to 75% from 2005-10, Wang reports. While only 10% of coal-fired power stations had flue-gas desulphurisation equipment in 2005, 86% had installed it by 2010. Wang also notes that pressure from above encouraged officials to co-ordinate across bureaux, previously a rare occurrence, and companies failing environmental inspections were unable to get approval for new projects.

Environmental improvement cannot rest solely on investment

All of the 11th FYP targets were hit, officially – which shows that the assessment system does sometimes work, and can be re-oriented towards new goals. Wang knows that the system is not perfect. There is widespread scepticism about the accuracy of China's energy and pollution numbers (*On the Ground*, 11 October 2010, 'China – The growth implications of energy controls'). He also explains the weakness of the assessment methodology; emissions reductions are calculated based on the estimated impact of investments in environmental equipment on emissions rather than actual measures of reduced pollution. There are clearly problems with the target approach – it misses hidden costs, ignores whether investments are effective, and discourages the move to effective monitoring and fines, the only way to really reduce pollution in the medium term. But still, Wang argues, the targets had an effect.



Some ideas for improving the performance assessment system

It appears that some thoughtful people in Beijing are starting to question China's performance system for officials. Recent articles in the *People's Daily* have taken local governments to task for building surplus manufacturing capacity, and even suggested that GDP targets are partly to blame (see '地方政府好大喜功 一哄而起乱铺摊子', and 产能过剩现三大顽疾 取消省级 GDP 核算值得考虑'). Somehow, the system has to be re-engineered to change the behaviour of all those officials. What can be done?

Here are some ideas for improving how we measure local government official performance

- Indicators like GDP, FAI and fiscal revenues could be downgraded to 'soft' targets, or even eliminated entirely. GDP targets have already been removed in some city districts and counties, according to Guo Yu at Shanghai's Development and Reform Commission. He supports the idea of provinces scrapping them too. This is not a perfect solution since, as Graeme Smith showed, these targets are not the only driver of cadre behaviour – budget and off-balance-sheet revenues are also key. But it would be a start.
- Selected 'soft' targets, such as education (enrolment rates, graduation scores, etc.) could be expanded, assigned higher scores, and converted into 'hard' targets.
- We believe the number of jobs generated, particularly service-sector jobs, is a performance parameter worth researching. The government's current system for surveying the labour force is pretty poor, though, and will require much more work before it can provide the basis for such a performance indicator.
- Services as a proportion of GDP could be given more weight as a performance metric (it is already used in some areas), though the quality of the data is likely to be an issue.
- Satisfaction surveys could be used more. Prof. Hu Ruifa at the Chinese Academy of Sciences has studied a trial reform a few years back in Pengzhou City in Sichuan, where government agriculture technicians' performance was measured based on feedback from farmers. Not only did this system encourage more useful visits, but it also apparently helped level the balance of power between the technicians and farmers, with the farmers feeling empowered to ask more questions. Deng Guosheng at Qinghua University has helped design and carry out random sample surveys in places including Dalian and Nanjing on the level of government-provided services in areas such as health and education. Objectively and independently carried out, such surveys would be an ideal next step in the assessment process. However, Prof. Deng did not seem confident that such an approach was about to be rolled out nationally. "So far, these are just local experiments", he said.
- We therefore propose that the State Council establish a dedicated working group to work with the Party's Organisation Department on a national transformation of the performance assessment system. Different localities will of course need to have different targets to suit their circumstances, but the authorities also need to recognise that, left to their own devices, localities will not significantly change the assessment system. We need top-down change to start transforming incentives.



None of the revised performance metrics we propose above are perfect. But if Beijing is serious about changing the growth model, it seems to us that ideas along these lines need to be introduced. While the performance system is certainly not the only thing that motivates behaviour at the grassroots level, it is important – and given China’s complexity, it strikes us as one of the easier things to change.

Some ideas for broader reforms that would improve local governance

But reforming the assessment system is not enough; we need to change the environment in which local officials operate if we are to successfully change behaviour

The above reforms are necessary, but they will not work alone. As our experts have explained, local officials are motivated by a lot more than just scoring points on their assessments. Some of the broader reforms we are calling for would radically shift these other incentives for officials’ behaviour (*On the Ground, 7 January 2013, ‘China – Dreaming of economic reform in 2013’*). For instance:

- **Declaration of officials’ private assets.** We believe intra-Party competition for leadership posts at the local level is a prerequisite for improving governance. The quality of this competition would be enhanced if it were combined with requirements for officials to declare their private assets. The issue of asset declarations has attracted much public comment in recent months, and two cities in Guangdong are reportedly starting such experiments. In order to smooth its introduction, asset declaration could be required for those wanting to be promoted. This would help to clean up the bureaucracy over time, and limit protests by officials unhappy with the new disclosure rules. Competition for posts among ambitious officials would mean that some who falsely report assets would be more likely to be found out in the rough-and-tumble of intra-Party elections, as their opponents might decide to disclose for them.
- **Make sure the new priorities are funded effectively.** Prof. Wu Jing argues that China’s pollution problem can be solved only if measurable environmental targets are prioritised, and that appropriate funding must be provided to fulfil those targets. This gets to the crux of the challenge to local government activity: stable, well-targeted funding. The most common complaint of our Hong’an friends was that the central government ties them up in knots in the way it allocates funds. Many of the fiscal transfers made by Beijing’s ministries are tied to particular projects; as a result, our trainees spend much of their time lobbying for funds from the ministries or are unable to use the funds they do receive for the important stuff. Funds are disbursed among dozens of pet projects, sometimes arrive late, and usually carry an arduous requirement for local matching funds. When we asked what they hoped to see from the new government, the answer from Ms. Hu, a forthright young Party Secretary, was clear: Give us the flexibility to spend funds as we need. Such a demand would entail (1) concentrating funds currently spread across numerous ministries, (2) pushing more funds into general transfers and away from project-specific transfers, and (3) reducing the local-matching requirement. Beijing’s ministries worry that untying funds from specific projects would lead to waste and corruption, so this problem is not easily solved.
- **Provide localities with additional sources of tax revenue, and centralise funding for national priorities.** Allowing local governments to keep a greater share of tax revenues, and/or allowing them to levy new local taxes to fund priority areas, is another topic of hot debate these days. Many economists (including ourselves) advocate a nationwide property tax, which would provide a stable and equitable source of revenue for city governments. This would help

Local government finance is a bit of a mess; one priority is rationalising the transfer system



move cities away from the ‘expropriate, lease and build’ circle of urban development to which so many are addicted (*On the Ground, 6 March 2013, ‘China – A little hope for land reform... in Shenzhen’*). A property tax would also reduce local governments’ incentives to keep land prices elevated, and it would increase holding costs for those owning multiple empty apartments. The property tax, however, is an extremely complicated political issue. Not only would it be unpopular among urban home owners, but it would likely cast light on officials who own dozens of apartments. Its introduction will come down to the political will of Beijing’s new leadership, and is therefore a critical test of their ability to get stuff done. A parallel reform idea to increase local government fiscal resources, without the political sensitivities, would be to allow local governments to retain a greater share of VAT and income taxes (and remit a smaller portion to Beijing).

We also need to consider centralising some of the spending responsibilities that localities currently shoulder. Education is an obvious one. Some 70% of education spending in China is handled by local governments, resulting in large disparities in per-student spending across the country. This is a big problem. Since the future of the country depends on nurturing a quality labour force, education spending should be nationalised at the Ministry of Finance level, ensuring that children in both poor and rich areas of the country get a quality education.

Banks need to escape local government influence in their lending decisions

- **Separate local government from local banks for good.** Finally, local governance would be vastly improved by separating, for good, the ties that bind local government to local banks. The most dangerous parts of the hidden local public debt build-up of recent years have occurred in banks and credit co-operatives wholly owned by local governments. Unlike the national banks, these institutions are extremely vulnerable to pressure to fund local officials’ pet projects. We support the gradual privatisation of local city commercial banks and co-operatives, as well as allowing Small Loan Companies (of which there are now several thousand registered with the People’s Bank of China) to take deposits and convert to banks without having to attract state-owned banks as backers. Another possible (albeit imperfect) solution would be for national banks to take over local banks. We also support the introduction of a bank deposit insurance system as a means of facilitating the resolution and closure of troubled banks. Only if banks face a legitimate threat of closure for bad behaviour can we hope to hold them fully responsible for the loans they make. And only if that happens can banks become insulated from political pressure to lend to local infrastructure projects.

The new leadership team in Beijing is, reportedly, considering many of these institutional reforms. As 2013 progresses, we will learn more about their thinking. The Party’s Third Plenum meeting in September/October 2013 will be the time to see this economic thinking. Apart from this, though, there is not much of a timetable by which to track progress.

To summarise, we believe that the answer to the question of how one gets promoted in China needs to change over the next five years. Party Secretary Xi and Premier Li will change China if they can change the behaviour of the millions of officials who, day to day, really run the country.



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