

Background paper prepared for the World Development Report 2005

Policy Reform on Investment Climate

-----Case analysis of Hangzhou

Pu Yufei

Sheng Lei

Yao Yu¹

State Information Center

March 29, 2004

Abstract

This paper studies the investment climate reforms in Hangzhou, in the context of those of the economic system in China. It describes the different waves of reforms, the forces behind them, and the effects of the reforms. Through historic and comparative analysis, the study draws the following basic conclusions. First, investment climate reform is a long process. The strength of each group grows and declines at times. Second, the reform and open policy by the central government is a strong force in promoting the improvement of the investment climate in Hangzhou. Third, the municipal government of Hangzhou was in a leading position to improve the investment climate. Fourth, whether the investment climate is good or bad has a strong impact on the economic development of the region. The course of the gradual improvement of the investment climate in Hangzhou is that of the gradual enhancement of the overall economy.

¹ Thanks to Hu Jun and Liu Min from Peking University for their discussion on the paper, and thanks to Ma Sidong, director of Hangzhou Information Center for providing relevant information. The views expressed are those of the authors and do not necessarily reflect official views of the World Bank.

Contents

Introduction	5
A) Clarification of the concept of investment climate.....	5
B) Clarification of the geographic region for study.....	5
C) Scope of reform on investment climate	6
D) Division of main interest groups and impetuses to the reform	6
Part one	
Background of the reform: the change of market players	7
A) Main contexts, features and effects of the reform	7
B) Reasons for the reform.....	8
a) <i>Purposes of the reform</i>	8
b) <i>Impetuses to the reform</i>	8
C) Main barriers on the improvement of investment climate.....	9
a) <i>Barriers in market entry/exit</i>	9
b) <i>Lack of flexibility of the labor force market</i>	11
c) <i>Insufficient infrastructure facilities construction</i>	12
D) Interest groups and change of benefits	12
a) <i>Local government</i>	12
b) <i>State-owned sector</i>	13
c) <i>Monopolizing industry</i>	13
d) <i>Private sector</i>	13
e) <i>External interest groups</i>	14
Part Two	
Process of the reform: gradual improvement of market environment	14
A) Strategy and mission of the reform.....	14
a) <i>Policy adjustment</i>	14
b) <i>Mission of the reform</i>	14
B) Reasons for the reform.....	16
a) <i>purpose of the reform</i>	16
b) <i>impetuses to the reform</i>	16

C) Main context of the reform of the market environment.....	17
<i>a) Reduction or elimination of barriers to market entry/exit.....</i>	177
<i>b) Flexibility of the labor force market.....</i>	23
<i>c) Infrastructure facilities construction</i>	244
D) Mechanisms of the reform	25
<i>a) Decision making mechanism</i>	255
<i>b) Execution and coordination mechanism.....</i>	277
<i>c) Information transmission and social mobilizing mechanism</i>	277
<i>d) Assessment mechanism.....</i>	299
<i>e) Incentive mechanism.....</i>	30
<i>f) Compensation mechanism.....</i>	31
<i>g) Resource reorganization mechanism.....</i>	33
Summary.....	34
Impacts of the reform	36
Appendix	38
References	45

Index of tables

Table 1: Degree of satisfaction with government service in Hangzhou	23
Table 2: Change in the number of employees of state-owned units in Hangzhou (year 2000-2002)	31
Table 3: Direct foreign investment over the past six years (unit: ten thousand US\$).....	37

Index of Charts

Chart 1. Change of municipal construction in Hangzhou.....	25
Chart 2. Staff of state-owned units in Hangzhou (divided according to subordination).....	31
Chart 3. Staff of state-owned units in Hangzhou (divided according to the type of units).....	32
Chart 4. Change of GDP and its Index in Hangzhou.....	35

Appendix:

Chart 1: Comparison of size of market among cities.....	38
Chart 2: Comparison of productive forces among cities.....	39
Chart 3: Score in entry/exit barriers.....	39
Chart 4: Comparison of policy on labor market among cities.....	40
Chart 5: Informal payments.....	41
Chart 6: Obtainment of fund.....	41
Chart 7: Portion of companies obtaining loans by informal payments.....	42
Chart 8: Score in finance.....	43
Chart 9: Comparison of internationalization among cities.....	44
Chart 10: International unification Index.....	44
Chart 11: Duration of trial by the court (unit: month).....	45

Introduction

A) Clarification of the concept of investment climate

According to the definition of the World Bank (David Dollar, AnqingShi, ShuilinWang and Lixin ColinXu, 2003), investment climate in a broad sense is divided into three levels. The first level is the macro environment, mainly referring to the stability of the economy and politics; the second level is system environment referring to the efficiency of the laws and regulations; the third level refers to the quantity and quality of infrastructure. The investment climate in a narrow sense is weighted mainly by ten important indices, including infrastructure, market entry/exit barriers, technology and skills, flexibility of the labor market, internationalization, participation of the private sector, informal payments, tax burden, judicial efficiency, and financial services, etc. We will take the definition and index system of the World Bank to weight the change of investment climate in Hangzhou.

B) Clarification of the geographic region for study

Hangzhou is one of the birthplaces of Chinese culture, with more than 2,200 years of history. The administration area of Hangzhou includes eight districts, three county-level cities and two counties. Hangzhou has an area of 16,596 km², with a population of 6368.1 thousand. The area of urban district of Hangzhou is 3068 km², with the population of 3870.1 thousand. The entire Hangzhou District is under the administration of the municipal government of Hangzhou, policies are also carried out within the whole district. Therefore, whenever we mention Hangzhou in this paper, we refer to the entire Hangzhou District instead of the urban district. Hangzhou is the capital of Zhejiang province, meanwhile it is a vice-ministerial city determined by the central government. Policies concerned with investment climate in Hangzhou are thus partially worked out by the municipal government, partially pushed forward by the Zhejiang provincial government and partially are executions or details of regulations enacted by the central government. The investment climate policies in Hangzhou, which are mentioned in this paper, include not only the local rules and regulations, but also parts of laws, regulations and development program of the provincial or central government.

C) Scope of investment climate reforms

The investment climate reforms in Hangzhou are based on those of the economic system in China. The economic system reforms in China are divided into three

historic stages. The first stage started from the year 1978 when the Chinese government adopted reform and open-door policy; it lasted until the outbreak of the Asian financial crisis in 1997. During this stage, the existing benefit structure remained untouched, while the private sector was encouraged to develop rapidly. If we use the words of the Chinese economists (Li zhou, Lin Yifu in 2003) as reference, this stage is called a stage of additional reform. The second stage started from the outbreak of Asian financial crisis and lasted until the year 2001 when China joined the WTO. At this stage, reform was carried out within the stock fields. Efforts were focused on the reform of state-owned enterprises and government institutions. Infrastructure construction was strengthened and the market environment was reorganized. In correspondence to the first stage, the second one is called a stage of stock reform. The third stage started from China's entry into the WTO. Policies are mainly focused on the speeding-up of market processes; it also includes an internationalization process, which goes with the trend of globalization and requirements of the WTO. The policies mainly include the adjustment of government functions, development of a regional strategy for development and deepening of infrastructure construction, etc. This stage is thus called a stage of comprehensive reform.

In correspondence to the stages of economic system reform in China and features of investment climate reforms in Hangzhou, we will introduce the investment climate reform in Hangzhou in two parts, which are *the change of market players* and *the reform of the market environment*. In Part One, we will introduce the development of private sector and the reform of state-owned enterprises at the stages of additional and stock reform. In Part Two, we will focus on infrastructure construction, reorganization of the market environment and the adjustment of governance structure at the stages of stock and comprehensive reform. We will stick to the principle that a simple discussion will be covered about the earlier stages and a detailed discussion about the latest stage, with the key discussion on the reform of the market environment.

D) Division of main interest groups and impetuses to reform

Five interest groups from different sectors are concerned in over 20 years of investment climate reform in Hangzhou; they include local government, state-owned sector, monopolizing industry², private sector and external interest groups. A detailed

² State-owned sector mainly refers to the state-owned enterprises and institutional units subordinated to the government of Hangzhou. Monopoly industry refers to

summary will be shown about the track how the benefit of each interest group grows and declines and how the impetuses are put into play.

Part One

Background of the reform: the change of market players

A) Main contexts, features and effects of the reform

Two aspects are included in the change of market players, which are vigorous development of private sector at the stage of additional reform and acceleration of privatization of state-owned sector at the stage of stock reform.

At the stage of additional reform, a gradual reform of the economic system was pushed by the central government. The provincial government in Zhejiang adopted a series of policies to speed up the market process and promote the local economy. To bring the production units at the grassroots level into play, the municipal government Hangzhou sought, within the policy framework decided by the central and provincial governments, to foster market forces without affecting the fundamental benefit structure of the state-owned sector. In this way, the government managed to create an investment climate for free development and fair competition. The private sector then achieved rapid development.

At the early stage of reform, there was no experience with a market economy, policy was made and carried out under the principle of *crossing the river by feeling stones*. Zhejiang is the pioneer of policy reform, there was no scheduled program, neither was there a complete set of pre-assessment system. *Crossing the river by feeling stone* is in fact a *test-error* method. If the reform is tested wrong, we will come back to the start point, draw lessons and try another way to continue; if it is tested right, we will carry out the reform and extend the experience to other places, producing a spread and study effect.

Low cost was the advantage of the investment climate in Hangzhou at this stage. Compared with the situations in other cities, the private sector in Hangzhou had fewer constraints from the local government, foreign capitals enjoyed more favorable policies, and the operation cost was relatively low. The private economy then gained

monopolizing industries such as telecommunication, bank, post-office, electric power, petroleum, railway and airlines, they are of vertical leadership system with management and reform modes different from that of the state-owned sector

rapid development, and the private sector in Zhejiang and Hangzhou took a leading position in China, both in total amount and in ratio. When the private sector in other cities developed rapidly, the system-related cost advantage in Hangzhou became less obvious. In the meanwhile, governments in other cities managed to attract more foreign capitals and adopted more favorable policies. The central government set up more restraints and norms on favorable policies about land selling and tax revenue, and the policy-related cost advantage in Hangzhou also became less obvious.

In response to the Asian financial crisis in 1997, the central government raised a policy of expanding domestic demands to maintain the sustained, rapid and healthy growth of the national economy. Positive fiscal policy and stable monetary policy were then addressed. Meanwhile, reforms on government institutions, state-owned enterprises, monopolizing industries, financial system, education system and dwelling houses allotting system were deepened. The reform in Hangzhou at this stage was directed to the state-owned sector and the government itself. The staff in the government institutions was reduced, the system of state-owned enterprises was transformed, a positive measure was taken for infrastructure facility construction, and the market order was reorganized. The market process was then sped up; great improvement was achieved in the investment climate. 85.6% of state-owned enterprises as well as 96% of township enterprises in Hangzhou were transformed by the end of the year 2000.

B) Reasons for the reform

a) Purposes of the reform

At the stage of additional reform, the purpose was to activate the production enthusiasm of the units at grassroots level and to promote the economic growth. At the stage of stock reform, the purpose was to reorganize the economic structure and ownership structure, and to change the means for economic growth.

b) Impetuses to the reform

Government

Governments at different levels have different impacts on the reform of the investment climate in Hangzhou. The central government and the provincial

subordinated to the government of Hangzhou.

government in Zhejiang are important supporters, pushers and assessors. The local government is a policy maker and executor. It is also the final executor of a policy made by governments at higher levels.

Private sector

The private sector is always an important force to investment climate reforms. The impacts are different at various stages of the reform. The private sector made giant strides and achieved remarkable success at the stage of additional reform; it thus became a kind of pulling force to the reform, guiding the direction of the market process. It was an economic force that could not be under-estimated in the course of reform of the state-owned enterprises. It became a challenge to the state-owned sector, attracting human and other resources, and demanding fair competition. It became a force to the improvement of the investment climate, which is free-competition oriented.

External interest groups

External interest groups that had an impact on the reform at the additional stage mainly came from neighboring cities. At the early stage, both the development of the private sector in Wenzhou model and the development of the collective sector in Southern Jiangsu model had deep impacts on Hangzhou. Between the two models Hangzhou was once plunged into hesitation, exploitation and swing. At the stage of stock reform, the reform of the state-owned enterprises in the Yangtze River Delta was accelerating, the private sector was growing rapidly, the ownership structure in different cities was gradually becoming similar, and the comprehensive urban competitiveness became a new core for competition. Under these circumstances, the scope of the reforms in Hangzhou was changed from ownership to the market environment.

C) Main barriers on the improvement of investment climate

a) Barriers to market entry/exit

There are five types of barriers to market entry, which are ownership restriction, unit restriction, industry monopoly, administration monopoly, and locality blockade. There are correspondingly five types of barriers to market exit, which are ownership protection, unit protection, industry protection, administration protection, and locality

protection. Besides, lack of social security system is another important issue.

Ownership barriers

Public utilities, culture and education, news and press, scientific and research academies or institutions used to wholly state-owned, without any private capital. Even if it lost money in business, the state-owned capital would not exit easily. The economy was occupied mostly by *institutional units*³, which were of Chinese characteristics. With the advancement of market process, the traditional features of institutional units are becoming increasingly vague. Some units were called *the second government* because they undertook certain type of administration functions on one hand and participated in market competition on the other hand. The market was then in disorder. Some other units gained profit in business activities, but got financial allocation from the government in the meanwhile. Governments at different levels were then in a tight financial situation.

Unit barriers

Unit is also of Chinese characteristics. Every state-owned institution was a unit, undertaking missions of administration or social production. It also played an important role in social stability and coordination. Many units including state-owned enterprises had their own systems; apart from their core business they had series of affiliated organizations such as dining halls, dormitories and hospitals for the staff, or even schools. Units kept the private sector away; they rejected any service from the private sector, so the markets in housing, medical care and education were kept from growing.

Monopoly industries barriers

Monopolizing industries such as telecommunication, electric power industries, civil aviation, railway and postal service were the main barriers for free competition.

³ Institutional unit is a product of the planned economy, its main characteristic is non-administrative, non-profitable and of public welfare. It is mainly subordinated to a particular government agency. It is set up and funded by the government. The fund is of three types: totally fiscal appropriateness, balancing appropriateness and self-income and cost.

Local interests barriers

Local government was an important interest group at the early stage of market process; its interest was in line with that of local enterprises. The local enterprises made contributions in tax revenue and GDP growth, thus creating jobs. Many local governments exerted their efforts to squeeze out the products of the external enterprises. They kept the market for local enterprises by administrative means or even by law. The trans-regional barrier was a headache against the establishment of a unique nationwide market. The municipal government of Hangzhou used to adopt policies for locality protection.

Government agencies barriers

Many government agencies reserved administrative approving power. The administrative approving powers that were over-detailed, abused and overlapped, kept on the discrimination of ownership, protected industry monopoly, led to locality blockade and kept the production factors from free flowing.

Social security barrier

Because the *unit* system undertook the *from-birth-to-death* service and security of most of the urban population, the level of social security was thus very low.

b) Lack of flexibility of the labor force market

The labor force market in Hangzhou was under strict control at the stage of additional reform; for example, the municipal government of Hangzhou issued *Stipulation on Management of External Temporary Worker* in June 1990. In the stipulation an external temporary worker was defined as a provisional and seasonal worker who came from places beyond any district or town of Hangzhou city and had work permission of less than one year. It was stipulated that any institution in Hangzhou City including joint ventures, sino-foreign cooperative enterprises, foreign enterprises of sole proprietorship, should recruit external temporary workers within the district or town of Hangzhou city. If external temporary workers were in bad need, they should be recruited within the counties under the administration of Hangzhou city. *Stipulation on Recruitment of External Laborers* was issued in September 1996. In the stipulation

enterprises were requested to recruit external laborers in line with the principle of priority to the local residents and township residents. If enterprises were really in demand of external laborers or a type of workers that were restricted, they had to ask for approval before their recruitment. Meanwhile they had to employ local laborers, the percentage of the local laborers should not be less than 20-50% of the overall recruited external laborers. Enterprises would be punished if they recruited external laborers without authorization.

c) Insufficient infrastructure facilities construction

Regarding to traditional infrastructure facility projects the government was in charge of both the investment and management. On one hand the government could not meet the demand of rapid economic growth because of its limited ability in investment and management, on the other hand infrastructure facilities were not open to private participation. At the early stage of market process the private sector was not able to run the large-scale infrastructure projects because of limited capital and market experience.

D) Interest groups and change of benefits

a) Local government

The municipal government of Hangzhou had less and less direct anticipation in the economic activities because of the vigorous growth of the private sector. The fundamental function of the market to allocate resources became stronger and stronger, so the administrative power of the government was weakened at certain extent. In the meanwhile, the government gained high returns because of the rapid growth of local economy, with fiscal revenue increasing at large scale and officials achieving obvious improvement in welfare. But the relative income gap between officials and entrepreneurs was widening, which was quite a shock to the traditional *official-centered* concept. Some officials quit their job, i.e. resigned their positions as public servants, and took positions in private sector or held a company of their own. Some other officials tried to add items for approval so that they were able to seek power for their own interest, and the increase in informal payments was the direct result.

b) State-owned sector

At the stage of additional reform, the state-owned sector was the beneficiary, without any direct shock to its entire benefit. With the deepening of reform in allotment system and personnel system, the staff in the state-owned sector improved a lot in salary and welfare, which stimulated the production enthusiasm and enhanced the economic interest. The benefit and the income of the staff at this stage were still low compared with the rapid development of the private sector. At the stage of stock reform, state-owned sector was the main object of reform. Its staff was the direct loser of the reform. The scale of the state-owned sector in Hangzhou was relatively small. People were less bounded by traditional concept because of years' of market reform. The government kept improving the social security system and adopting series of buying-out policies⁴, loss was in relative meaning. Some managers obtained part of equities in the process of privatization of state-owned enterprises; they didn't suffer from loss at all, on the contrary they gained a lot from the reform.

c) Monopolizing industry

At the stage of additional reform, the expanding market had sharp demands on monopolized products such as telecommunication and electric power, but no reform was taken at this stage to touch the internal management and structure, so the monopolizing industry was the major beneficiary at this stage. At the stage of stock reform it was an object for reform, it was disassembled and reorganized, so it was the main loser.

d) Private sector

At the stage of additional reform, the private sector was obviously the biggest beneficiary. At the stage of stock reform, there was few opportunity of getting rich rapidly because of the standardization and restraints of more policies. With the continuous improvement of the competitive environment, the social status of the

⁴ In 1999 the municipal government of Hangzhou put forward *opinions on helping the municipal affiliated big and medium state-owned enterprises out of their deficit*. The government encouraged the enterprises to be transformed into share-cooperative ones, it offered favorable policy and encouraged the enterprises to sell assets such as idle machinery and workshops to their employee for operation so that the employees could make up the potential loss occurred from the reform.

private sector kept growing, so the room for development became broader.

e) External interest groups

At the stage of additional reform, the economy in Zhejiang and Hangzhou mainly relied on internal resources for development, without large number of foreign investors rushing. With the deepening of the open-door policy in Hangzhou, the benefit for external interest groups was also increasing.

Part Two

Process of the reform: gradual improvement of the market environment

A) Strategy and mission of the reform

a) Policy adjustment

Since the financial crisis in Asia in 1997, the municipal government of Hangzhou has shifted the investment strategy from the change of market players to the creation of a better market environment for competition. With the initiation of transparent and just law environment, a fair market was in order; resistance against market competition was eliminated. Infrastructure facilities of higher level were constructed, the government then provided coordinating service to attract investors, to win the trust of investors and to establish their confidence.

b) Mission of the reform

Investment climate reforms in Hangzhou are focused mainly on five aspects such as market process, internationalization, industrialization, information process and urbanization. Among them, market process and internationalization are the two main issues, which are the cores of the investment climate.

There are three key points in market process. The first one is to further promote the development of private sector, to stir up the vitality and to encourage the private companies to go public for financing. The second one is to further promote the system transformation of the state-owned enterprises, to reach the objectives that not only the ownership structure, but also the corporate structure, will become normal and

favorable to market competition. The third one is that the government tries to avoid the phenomenon of offside, vacancy and mal-position, it will be in line with the principle of mustering resources for the good of the market and change itself into a service-type government.

Internationalization mainly refers to meeting the demands of the WTO and joining the process of economic globalization. The paths to achieve this objective include the construction of three groups. First, to participate in the development of the Yangtze River Delta Region, adapting to the global industrial layout, and setting up an industry group within cities of the region. The industry group will enjoy comparative advantage in global competition. The key is to keep track with Shanghai, relying on its advantages of being an international finance, information and trade center, and port, which will enhance the competition and cooperation with the international society. Second, to set up a round-Hangzhou Bay industry band by making an overall program for the region; which possesses a comparative advantage over other places within the Yangtze River Delta Region. The advantage will become the core competence for the whole Hangzhou Bay Region. Third, to set up industry chains within the Hangzhou Bay Region, especially in the development zone, with several dominant products. In this way foreign capitals will be introduced at large scales and numbers of big enterprises will be fostered to provide collaborating products and services for the medium and small enterprises.

Information processes will be realized by building a *Heaven Silicon Valley*, encouraging technology introduction and innovation, cultivating a failure-tolerating culture, fostering new industries such as information technology, new materials and biological pharmacy, speeding up the construction of electronic-government. The process will promote the development of industrialization.

Industrialization initiates the strategy of *industry-build-up-city* and *industry-prosper-city*. In the process of service industry development, investors on key industry projects will be introduced to support the local industry and to speed up the development of the industry of the whole region.

The core of urbanization is the strategy of *big-city development*, which includes *enlarging the city eastward, forwarding tourism westward, along-the-river development and cross-river exploitation*. A networking big city will emerge, with downtown as the center, counties as backs, and key towns as bases. Within the city, resources will be shared, functions will be of mutual help and everything will go in harmony.

B) Reasons for the reform

a) purpose of the reform

The purpose of the reform was to adapt to China's entry into WTO and the unification of global economy, and to promote another round of economic growth so that the comparative advantage of Hangzhou would take into play and turn into a competing edge.

b) impetuses to the reform

Government agencies

China's entry into the WTO speeds up the change of government from a management type to a service type, with an increasing portion of experts and technical staff working in government agencies and taking part in decisions⁵. Concept change of the government, improvement of decision quality and enhancement of policy transparency has left profound impacts on the reform.

Private sector

With the furthering of market process, private capital was smooth in trans-regional flow; the smoothness became a kind of *pressure* on the improvement of investment climate.

External interest groups

When more investors were attracted to neighboring cities or to other cities of the country, and many external investors came and left, there was an emerging pressure on the investment climate for improvement.

⁵ Since the implementation of the public servant system in 1994, the government staff has become younger and better educated. The government demand of professional technology and technique in planning, social management and economic regulation is increasing. The government increasingly cherishes technical persons, so their social status is also improving. On the other hand, the government attraction is increasing; the number of graduates who register for an examination to become public servants is increasing, their educational level is becoming higher and higher.

C) Main context of the reform on market environment

The reform on investment climate in Hangzhou includes several aspects, covering all the important indices in the World Bank report. We will mainly present three aspects of the reform such as barriers to entry/exit, infrastructure facility construction and elasticity of labor force market.

a) Reduction or elimination of barriers to market entry/exit

Reform on institutional units

In order to unify the status of the units, the municipal government of Hangzhou initiated a reform with *transform-unit-into-enterprise* as the core. There was resistance in both government agencies and institutional units.

There was a tradition that affiliated institutional units turned over part of the profits they gained in the market to government agencies. From the perspective of government agencies, transformation of institutional units meant direct loss of their interest, so they sought reasons against the reform. For example, some agencies were against the reform on the ground that the transformation of units would lead to loss of state-owned assets while some other agencies insisted private sectors should not undertake public utilities because it was impossible for them to supply public products⁶.

There were two types of resistance in the institutional units. The first type was that leaders of the units had administrative power or government background, they had long considered themselves as officials; therefore when they were running a business they were accustomed to waiting for customers to drop in. Once the reform was carried out they would lose the government background and had to meet the requirement of the market for competition, so it was difficult for them to accept the reform. The second type was that the institutional units had long been involved in market activities relying on their government background and resources, if they were separated from the government they would find it hard to survive in the market. Many employees were against the reform because they were afraid they would lose their interest or their jobs.

But the increasingly grown-up private sector asked for fair environment and equal status for competition, the products and service they provided were far better than that

⁶ Many cases show the reasons are groundless

of the institutional units. Under the financial pressure inside, together with outside pressure from the private sector, the government had to take advantage of administrative power to push the reform process.

Since 1998, a series of comprehensive and coordinating reform policies have been adopted in Hangzhou with equity reform as the main issue. The municipal government of Hangzhou put forward a proposal in August 2001 to reform its subordinated institutional units. In the proposal, all its subordinated institutional units, which were able to be independent in the market, should gradually be transformed into enterprises. It was also required that the task should be finished before the end of the year 2002.

In order to cope with the resistance against the reform, the municipal government of Hangzhou adopted two kinds of measures.

First, leaders in institutional units were allowed to obtain shares and options after the transformation of the units. Take the medium institutions engaging in identifying business as an example. Law firms, accountant firms, and appraising firms used to be affiliated to several government agencies. According to the reform program of the municipal government, these firms had to be separated from government agencies within a definite time. They would be transformed into partnership or limited companies, and the leaders could become partners or shareholders of the new enterprises. The policy stirred up the enthusiasm of the leaders. They were active in promoting the reform and accelerating the process of separating their units from government agencies because they were aware of the potential profit.

Second, outside competitors were introduced so that outside pressure emerged. Take the units in medical sector as an example. The municipal government of Hangzhou put the medical institutions under the management of state-owned asset management companies, the latter exercised the authority as a fund supplier, in this way the traditional administrative relationship was weakened. In September 2003, the municipal government of Hangzhou put forward a policy to provide six years of finance subsidy to private hospitals on the purpose of solving the problem of unfair competition, which was incurred from the differentiation of tax policies for profitable and non-profitable hospitals. The policy presented a strong attraction to investors. With the anticipation of private and foreign funds, the newly built private hospitals put pressure on public hospitals in terms of working mechanism and human resources, leading to the promotion of the reform on equity system of the public hospitals.

Separation of organizations affiliated to state-owned units

Carrying out the reform of state-owned enterprises and institutional units, the municipal government of Hangzhou separated the affiliated logistic agencies from units and made public. The huge units were then resolved and became market players with clear functions; a huge market was then open to them.

There were two types of resistance in the course of separating affiliated organizations from state-owned units. The first type was that the personnel working in units affiliated to the central government.⁷ The assets had to be locally settled down. Because this kind of units was of large scale, it became a pressure to reform in Hangzhou. The second type of resistance was that the employees in affiliated organizations were against the reform because they were afraid of losing their jobs.

Accordingly, the municipal government of Hangzhou adopted four kinds of measures. First, it helped to keep the newly separated enterprises in order, to make their business steady and grow up for further development. Second, it encouraged the private sector to merge or acquire the affiliated organizations and try to accept as many as possible employees. Third, it encouraged the employees to separate from the units and seek their own courses. The government would support them in terms of funds or in assets. Fourth, it encouraged part of the employees to buy out their length of service⁸ in the units and retire ahead of time.

Measures of the first type were adopted in the reform of the Logistic Group of Zhejiang University. Before the reform Zhejiang University was a self-styled institutional unit integrated with teaching, research, livelihood and production, just like other universities in China. The university had large logistic agencies, which were of low service quality but impeded the entry of outside competitors. To solve the problem a series of reform measures were adopted in Zhejiang University. The logistic agencies were put into imitative business operation in 1988. A company was set up in 1993, so that it was preliminarily separated from the administration system

⁷ Under the planned economy, the state-owned enterprises in Hangzhou were of different subordination relationship, they might be subordinated to the central, provincial, municipal or district government. By subordinated to central government, we mean they were subordinated to different ministries or commissions.

⁸ Buyout length of service means that employees are allowed to retire ahead of time but get salary according to certain standard for the period from the present time to their legal retirement. The enterprises have to prepay them the salary at one time, then the employment relationship between the employees and the enterprises is dismissed.

of the university. In January 1999 a group company was set up, and was put into full business operation. Recently, it was ready to be transformed into a stock company; foreign capital, private sector as well as co-operative enterprises were encouraged to join. In order to avoid monopolization a transitional favorable policy was adopted for market entry of outside competitors; the Group was also encouraged to open up to the outside market.

Reform of monopolizing industries

The municipal government of Hangzhou was active in coordinating with the central government in promoting reforms of monopolizing industries, and took flexible measures adaptable to local demands. For example, Hangzhou is very abundant in private funds. With the support of the government large amount of private fund has flown to infrastructure. The longest bridge in the world—the trans-sea bridge in Hangzhou, was started to build in 2003; the overall investment on the bridge is 11.8 billion RMB, above half of the investment is from private sectors such as Songcheng Group. The urbanization rate in Hangzhou is very high, industry develops very fast, and the problem of shortage of electric power is very serious. The municipal government of Hangzhou sped up reforms of the electric power system, broke the monopoly model based on electricity generation, transmission, distribution and supply being controlled by one power enterprise. The government encouraged the private sector to invest and build medium and small-scaled hydra-power stations. The International Small-scaled Hydra-power Center under UNIDO (United Nations Industrial Development Organization) was headquartered in Hangzhou in December 2000. By now, there are over 130 members who are government institutions and national organizations from more than 60 countries. International exchanges and cooperation in the development of hydra-power resources is thus strongly promoted. In breaking the telecom monopoly, a so-called *Hangzhou Model* is spreading among many cities. China Netcom, a competitor of China Telecom, is able to enter the Hangzhou market with the aid of other monopoly forces. Hangzhou Netcom Information Port Company Limited was established among China Netcom, the municipal government of Hangzhou and National Radio Film and Television Group (monopolizing the radio, film and television area). The company has made use of the government resources and the fiber system of the National Radio Film and Television Group, scrambled numerous cut-in businesses from China Telecom, and gained a large number of customers. It also obtained most of the orders from the municipal government. Within 10 days when the information port was built, China Telecom

Hangzhou announced to reduce half of the price for opening a network account.

Adjustment of locality protection policy

At present the municipal government in Hangzhou is trying to promote the adjustment of locality protection policy by adjusting the development strategy. Hangzhou is strategically joining the Yangtze River Delta Region and is actively taking part in the division work, selecting projects of its own comparative advantage, encouraging the local enterprises to make use of their competing edges and enter other markets. So long as the local enterprises become large and strong, objectives such as employment and growth rate will naturally be reached. Introduction of external dominant products also enhances the benefit level of consumers in Hangzhou.

Reform on administrative approval system

In order to further the change of government functions, standardize the administrative approval system, and reduce items for approval, the municipal government of Hangzhou issued a *Stipulation on Reform of Approval system in Hangzhou* in August 2000. The stipulation was aimed to raise efficiency, improve the investment climate, and to promote law-guided administration. It was stipulated clearly that all approvals must be law-guided, government agencies, as well as their directly subordinated institutions, must make public the context, object, requirement and time limit, simplify the approval procedures and standardize the process. Each agency (unit) had only one window to process all requests.

The municipal government in Hangzhou has gone through a winding process of reform of the administrative approval system because the reform has directly touched the vested interest of the government agencies.

A leadership group was founded for reform of the administrative approval system, which was headed by leaders of the municipal government of Hangzhou. The group was the formulator and also the executor of the reform scheme. The main difficulty that the group encountered was how to decide the items for approval. The information that the group had was dissymmetric to that of each agency. Each agency usually had two ways to cope with the group. The first way was to notify the group of the rights for approval of insignificant items while the second one was to try to justify the legitimacy, rationality and necessity of their rights for approval. Correspondingly, the group found out four methods to solve the problem. First, admitted experts who were

familiar with the operation of the agencies into the group. Second, set up a forum for government affairs on the government website and asked citizens and enterprises to report problems existing in the government approval process. Third, made use of the market and public opinion to promote reforms. Fourth, government leaders hosted meetings for face-to-face coordination. Since so many methods were followed, the resistance from agencies gradually became less and weak, and the overall reform process kept going.

The municipal government of Hangzhou carried out three rounds of reforms of the approval system in January 2000, 2001 and 2004. Most of the previous items of approval had been abandoned or consolidated. The items were reduced from 3200 to 389. While reducing the items of approval the government was active in promoting the reform of the managing non-government investment. In March 2003, the provincial government of Zhejiang chose Hangzhou as a test city.⁹ The approval system for non-government investment projects was changed into a registration system. There was a sharp increase of non-government investment. The non state-owned investment from January 20 to June 2003 reached 21.4 billion RMB, taking the rate of 61.5% of the aggregate social investment. Among it, non state-owned industry investment reached 7.373 billion RMB, with an increase of 52.5% over the previous year. The figures are reflections of the efficiency of the reform of the approval system. Take the approval of a production line building project as an example. In the past, it used to take 15 working days to get the approval. But now if you put items such as name of the construction unit, name of the project, hectare of the built-up area, total investment and sources of the funds into the computer, you will obtain the approval within a few minutes.

The following is a reflection of the overall change brought about by the reform of the approval system.

⁹ The provincial government of Zhejiang declared that *the management of recording of private investment in Zhejiang province* was to put into effect on Jan. 1, 2004. It was stipulated that apart from forbidden and restricted items, any project which was in line with state and provincial regulations and programs, and which was invested in Zhejiang by a citizen in China or legal person with his own fund, would be recorded without approval from the government in terms of project proposal and feasibility study. Now an investor who wants to register his project can obtain a *registration form for social fixed asset projects* in just a few minutes. The registration form is a replacement of an application form that is submitted to several government agencies for approval. It usually took at least half a month to get the approval in the past.

Table 1: Degree of satisfaction on government service in Hangzhou

Items	A (%)	B (%)	C (%)	Ranking
service quality	13.2	74	87.2	1
professional ethics	9.7	75.3	85	2
law-guided administration and standard management	10.8	72.2	83	3
transparency of government affaires	14.9	67.7	82.6	4
continuity of policies and regulations	11.5	70.8	82.3	5
work efficiency	15.3	66.3	81.6	6
building of social credit system	11.8	69.4	81.2	7
work performance of the personnel	9.4	69.1	78.5	8
planning and guidance on sectors and regions	9.4	68.1	77.5	9
administrative approving procedures	8.7	64.9	73.6	10

A: satisfied; B: generally satisfied; C: A+B

source: <http://www.hangzhou.gov.cn/main/file/article/5100/article-33049.jsp>

Establishment of social security system

When the barriers of ownership and units are removed, the establishment of a social security system must be taken into account at the same time. In line with the arrangement of the central government, the municipal government in Hangzhou set up and improved a series of systems such as endowment, medical insurance, unemployment insurance, and minimum living insurance. Free flow of production factors such as labor force were then effectively guaranteed.

b) Flexibility of the labor market

At the stage of reform of the market environment, the municipal government in Hangzhou abolished relevant procedures about labor discrimination. On one hand, the state-owned enterprise was pushed to the market so that the problem of redundant personnel would be solved; on the other hand, the social security system was improved to encourage irregular employment, demand estimates of labor was improved to reduce redundant personnel. Irregular employment was an important kind of system innovation. It implied that the laid-offs and the unemployed, whether initiated individually or collectively, took part in community services, city management services, housekeeping services, and various temporary or suddenly

occurring services for enterprises or institutional units. It also referred to the employment without stable working relationship, a kind of self-help activity with family handcrafts and art workshops as undertakings. The municipal government of Hangzhou supported the irregular employment in three ways. The first way was three-year exemption of sales tax and income tax. The second one was to pay interest for the employing organizations of the irregular employment when they applied loans from the bank. The last one was that the labor and social security agency would provide certain amount of subsidies to the irregular employment when they were engaged in public welfare or non-profitable activity.

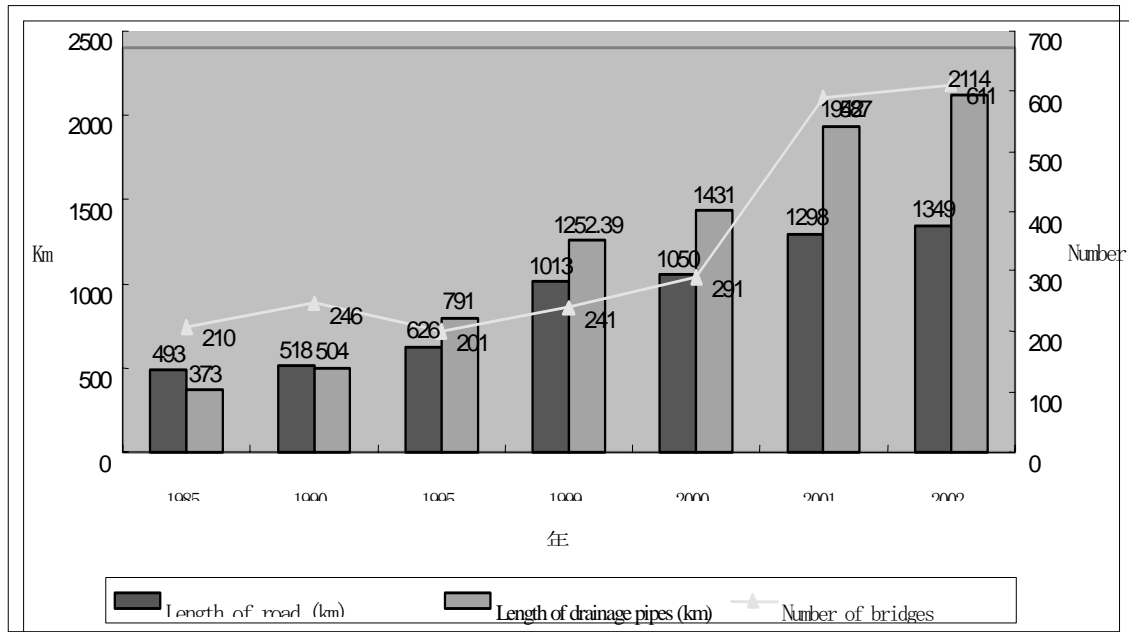
c) Infrastructure facilities construction

The government is in charge of investment and management for traditional infrastructure facilities projects. At the stage of reform of the market environment, the municipal government of Hangzhou was speeding up government investment, trying to develop financing channels, and finding new methods for project management and operation. Since 1998 great improvement has been achieved in the quantity and quality of infrastructure facilities construction (see Chart 1). In order to make a better demonstration, road construction is taken as an example.

The following measures were taken in the course of pushing traffic westward. Financial funds were invested in the principal projects via the shareholding investment companies subordinated to the district or county governments.

Gains from selling land alongside were invested as a shareholder's equity. The percentage was decided by the ownership of the land. Investor at home and abroad were encouraged to invest in the way of joint venture, cooperation or sole proprietorship, set up a limited company, of which fee collecting was the core business. The newly established company was allowed to set up collaborating facilities alongside the road such as filling stations, car-washing areas, service areas, warehouses, advertisement, etc. The company could ask for bidding, leasing or self-operation, it could also apply for comprehensive development projects including real estate. The company could get partial refund from the land-selling money.

Chart 1. Change of municipal construction in Hangzhou



D) Mechanism of the reform

The municipal government of Hangzhou has adopted eight mechanisms to promote the policy reform of the investment climate.

a) Decision making mechanism

The government is the main decision-maker of the reform investment climate reform. Governments at different levels have their relative share of decision-making power. Significant measures of reform of the monopoly industry is decided and arranged by the central government, reform of governmental institutions and the administrative approval system is initiated by the central government and executed by the local government. Important strategies such as joining the Yangtze River Delta Region, keeping track with Shanghai are put forward by the provincial government of Zhejiang. Meanwhile, the local government is responsible for drawing up a plan¹⁰. Reforms of the residence register system and system-transformation of state-owned

¹⁰ Lu Zushan, governor of Zhejiang province instructed leaders of the municipal government of Hangzhou that the main purpose of keeping track with Shanghai was to further enhance the level of *open to the outside*, to promote huge development by further opening so that huge enhancement would be realized.

enterprises are decided and executed by the local government. Usually, they get tacit consent as well as support and promotion from the government at higher level.

Decisions of the local government are usually in line with the principle of *raising questions, analyzing problems and solving problems*. There are five ways. The first one is that the higher-level government puts forward the direction or requirement of the reform, the local government organizes a group to study and come to a detailed regulation, for example the reform of the administrative approval system. The second one is that leaders of the government put forward an idea or a strategy of reform, ask experts or relevant government agencies to make an assessment, and then to put forward recommendations for decisions by the leaders. The third one is that the public or the media make a report. The government takes an investigation and then makes a decision to solve the problem. The fourth one is to learn from the experience abroad or from other cities, and to take measures to improve the investment climate. The last one is to raise a scheme of investment climate policy reform based on the suggestions or proposals of relevant government agencies or experts.

From the working regulations of the municipal government of Hangzhou, we can easily find out that government decisions become more and more programmed and systemized, the strength of law-guided administration is improving, and plans and laws are having continuous binding force on the government in decision making. Take the decision-making procedure for reform of the approval system as an example. In 2001, the municipal government of Hangzhou made it clear that any decision should go through the following five steps. The first step is survey preparation; an overall check-up will be done of the items for approval. The second step is the drawing of schemes; each government agency will submit its scheme to the Office of *Joint Meeting on Reform of Administrative Approving System*, a draft will be reached. The third step is requesting opinions. It is required that opinions from all walks of life should be asked for. The order at this step is to ask for opinion to the Municipal People's Congress and Political Consultative Conference first. Then to ask for opinions from the public, with extensive opinions from citizens. What comes next is to ask for opinions from each government agency. The fourth step is to exam, approve and release the scheme. The *Joint Meeting on Reform of the Administration Approval System* will come to a formal scheme and submit it to the standing meeting of the government for examination. After it is examined, the remaining items for approval will be made public and put for supervision from the public. The final step is to put the scheme into effect; the municipal government assigns a certain agency to

follow the track, get feedback and supervise the implementation.

b) Execution and coordination mechanism

The government agencies have a clear division of responsibility regarding the improvement of the investment climate. The development planning agency is mainly responsible for the overall planning for economic and social development. It is also responsible for the government's investment on infrastructure facility construction and its macro-management. The labor and social security agency is mainly responsible for the management of labor market and social security. Agencies of banking supervision, securities supervision and insurance supervision undertake their respective supervision in the financial markets.

Regarding items that need cooperation between agencies, there are two kinds of coordinating mechanisms. The first one is joint approval on the net.¹¹ The second one is a joint meeting for items that need repeated face-to-face discussion. Leaders of the relevant agencies are members of the coordinating team. Policy coordination is needed at the joint meeting.

c) Information transmission and social mobilizing mechanism

The ideas and policies of the municipal government of Hangzhou about the investment climate reforms are transmitted via two channels. Within the government body, often the document is read and a meeting is held, so that the information will be transmitted. Government decision is transmitted to the public via the media such as newspaper, television and Internet, so the public will know the government is determined to undertake the reform. Over the years, the website of the municipal government of Hangzhou has been playing an increasingly important role in

¹¹ In Oct.2000, the municipal government of Hangzhou set up a center specialized in dealing with investment projects. The center operates as follows: one agency accepts submissions and coordinates with other agencies. Approval was normalized and should be done within a time limit. A service for information inquiries was available on the website of Hangzhou investment network. Registration forms could be downloaded, and an information desk was also available. In January 2004, the center built a comprehensive information system for the investment network, with the purpose of normalizing the government procedures, enhancing work efficiency and service quality, and reaching a more transparent government administration. Parallel approval is realized.

information transmission. By browsing the website, the public can not only keep in touch with the latest renewed policy but also find out government documents, laws and regulations for the past six years. They can also find out data and reports on investment climate by searching the website.

The municipal government of Hangzhou makes good use of the media in mobilizing the citizens. First, publicity was given to introduce the development of the private sector, leaving a demonstrative effect on the society and encouraging residents and peasants to support and take part in the reform. Second, the public gave continuous support to the reform of monopolizing industry and state-owned enterprises at the stage of stock reform because they enjoyed real gains from the reform. Third, the government sought understanding and support from the public by interacting with them.

In regard to particular interest groups, the government will not only bring the media into play, it will also adopt various methods. Take the reduction of public servants as an example.¹² There are mainly three steps. First, submit an application to the People's Congress on the elimination of certain agencies. The People's Congress will then confirm the new government institutions. Second, determine persons in charge of the new institutions, and make three determinations, i.e. determination of function, determination of structure and determination of staff. Third, select staff and lay off the redundant people. At the first step, all the public servants have an expectation about the reform. At the second step, most of the public servants have their preliminary judgement about their own future. At the third step, the laid off servants have to be subordinated to the arrangement or seek jobs for themselves since the situation is settled. Regarding to state-owned enterprises or private sector, an important method for mobilization is to have test projects. The government will provide an all-round policy support to a state-owned enterprise that is under the test of system transformation, or give support to a successful private company so that they will have a better environment for development, and thus they will play an attracting and demonstrating role for other enterprises.

¹² Since 1982 there have been six reforms of the government structure in China, every reform is carried out from top to bottom, covering many agencies. The task of the reform in 1998 was to reduce institutions and staff, about 50% of the staff was laid off.

d) Assessment mechanism

At the stage of reform of the market environment, external assessment and feedback about the investment climate policy was obtained in four ways. First, invite experts to make a feasibility study and assessment of a policy that was under decision. In regard to infrastructure facility projects that would be invested or approved by the government, three phases of expert assessments were needed: project proposal, feasibility study and initial design. Second, establish a hearing system. Third, ask medium institutions to make a post-assessment of relevant policies. Fourth, interact on the government website between the municipal government and the public, set up various kinds of *forums on government affairs* and *government mailbox*, and invite enterprises and the public to make a direct assessment of relevant policies.

Let's take the hearing system as an example. In May 2001 the municipal government of Hangzhou started to implement the *Stipulation of Hearing System on Legislation*. It is stipulated that all legislative items that are concerned with the interest of enterprises or citizens, such as approval and charging, must go through the hearing system. Anyone who wants to attend the hearing has to enter his/her name on a list, and the final members who attend the hearing will be selected from the list. Members who are in favor of the legislative item are roughly equal to those who are against it. There are altogether ten people who will attend the hearing and make a speech. They include representatives of state-owned enterprise managers, customer representatives, lawyers, law professors and government officials. The hearers are representatives from relevant agencies. The significance of the hearing system lies on that the decision is made under the sunshine instead of evil. It also lies on that the decision is not made by a minority group. Since the mass has anticipated the assessment and public discussion, the power is operating more transparently and the science of the decision is guaranteed.

External assessment from a third party receives special attention. At the end of 2003, when the World Bank report ranking the investment climate in 23 Chinese cities was just released, it was closely examined by the municipal government of Hangzhou, the media and research institutes. Government agencies such as Hangzhou Economic and Trade Commission, academic institutions such as Hangzhou Business School, and media such as Hangzhou Daily started analyze the report, discuss the advantages, sum up the weakness and put forward proposals for reforms. A hot debate was undertaken among various walks of life of the society.

e) Incentive mechanism

Regarding various investors, several types of incentives are applied in Hangzhou. Favorable policy is offered to foreign investors. In 2001 the municipal government of Hangzhou issued a *Proposal for the Further Encouragement of Foreign Investors*. It encouraged foreign investors to take part in the system transformation of traditional industry by introducing advanced technology. It was stipulated that foreign enterprises of sole proprietorship and more than ten years in business, joint ventures or cooperative enterprises with more than 1.5million US\$ of actual investment are allowed to enjoy favorable policies. Beginning from the year when they make profit they are exempt from income tax for two years. They are deducted 50% of their income tax payments from the third to the fifth year. The government agency of finance will offer them support from the sixth to the tenth year when they gain profit by arranging certain sum of fund. The total sum of support cannot exceed 50% of the five years' income tax. When the enterprises spend the investment in importing machinery and equipment for their own use, the government agency of finance will arrange the income tax of the enterprises by offering them subsidies to compensate the tariff and import VAT. The total subsidies should not exceed 50% of the tariff and VAT on the machinery and equipment that the enterprise imports for their own use.

Direct reward is granted to those who bring capitals. The municipal government of Hangzhou issued a *Provision on the Management of Specific Fund in Introducing Capitals*. It was made clear in the provision that those who introduce foreign capital will be granted 3.5‰ of the actual investment as subsidy, those who introduce domestic capital will be granted 2.5‰ of the actual investment as subsidy.

In regard to the management team of the state-owned or state-shareholding enterprises, which have already been transformed or are still under system transformation, shares are the main incentives. The municipal government of Hangzhou issued an *Option Motivation for Managers of State-owned Enterprises* in 1999. Managers are encouraged to buy, directly in cash, state shares (assets) of the enterprise. When they hold the post, they are entitled to buy the state shares until the time when their term of office is due. The price of the shares is agreed upon on the basis of the net asset per share. Managers need to pay in advance.

Regarding managers of private enterprises, they get non-discriminative support economically. Politically, the outstanding managers of private enterprises are given honor and publicity. More private entrepreneurs are absorbed in government decision and social management.

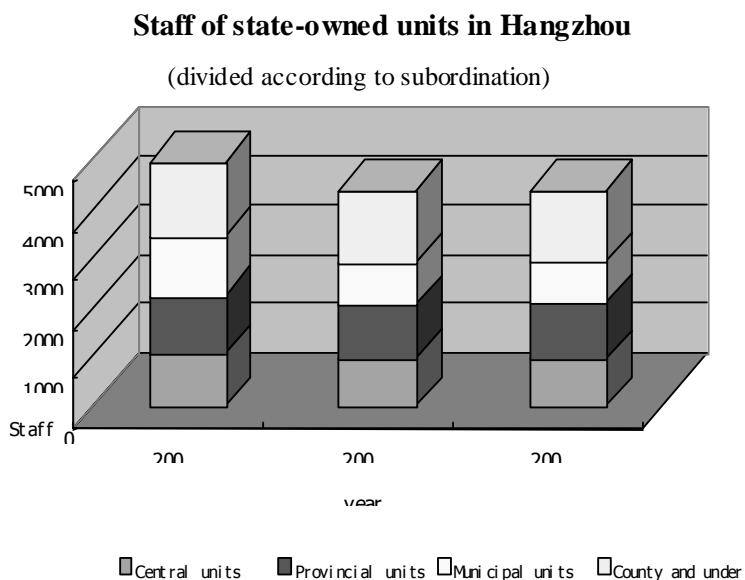
f) Compensation mechanism

With the furthering of reform of state-owned units over the years, the number of employees in state-owned units in Hangzhou has declined. The number declines from 497 thousand in 2000 to 434 thousand in 2002, a decline of 12.7%. The number declines faster in state-owned enterprises, it declines from 249 thousand from 2000 to 184 thousand in 2002, a decline of 26.1%. (see Table 2, Chart 2 and Chart 3).

Table 2: the change of number of employees in state-owned units in Hangzhou (the year 2000-2002)

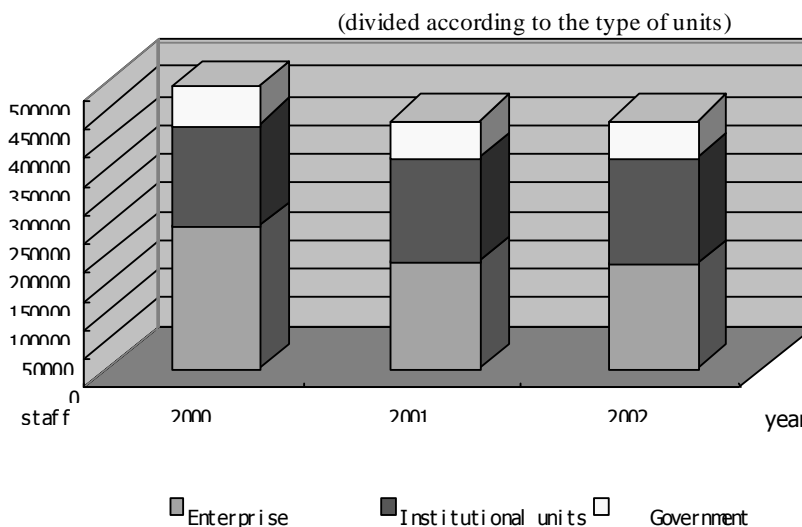
	year 2000	year 2001	Year 2002
Total number	496532	434647	434470
Enterprise	248643	188295	184480

**Chart 2. Staff of state-owned units in Hangzhou
(divided according to subordination)**



**Chart 3 Staff of state-owned units in Hangzhou
(divided according to the type of units)**

Staff of state-owned units in Hangzhou



Source: “Statistic Yearbook of Hangzhou City” (year 2000-2002,)

The municipal government of Hangzhou applies buy-out for the losers of the reform so that the resistance against reform will be eliminated. It is stipulated in a paper issued in August 2001 that when an institutional unit is under system transformation, its staff is allowed to retire ahead of time at his/her own will. Anyone with 20 years of service and is coming to the legal retirement age within 5 years (included) by Dec. 31, 2001 or anyone with 30 years of service is entitled to retire ahead of time enjoying the same treatment as the normally retired. His/her retirement will be checked by the unit and relevant authorities and approved by the Personnel Bureau of the government. The unit will pay the social security agency at one time the pension, basic endowment and basic medical insurance for the years between his/her ahead-of-time retirement and legal retirement age. When the unit dissolves relationship with its staff or he/she is permitted to resign and look for a job by himself/herself, he/she will get compensation according to his/her years of service in the unit. He/she will be compensated one month of basic salary for every one year of service in the unit, if the service is less than one year it will be counted as one year. The criterion is in accordance with his/her average basic monthly salary 12 months before the dissolution of the employment relationship.

Apart from the buy-out policy, there is another kind of important compensation mechanism, which is the establishment and improvement of social security system. Hangzhou takes a leading position in China in establishing social security system.

g) Resources reorganizing mechanism

Experiences in resource reorganizing have been done in Hangzhou City. In regard to land resources, enterprise lay-out is adjusted by replacing lands since the aggregate land is very limited.

In regard to human resources, talented people are attracted from universities such as Zhejiang University. The principle for attracting human resources is striving for what is needed instead of striving for all. A typical example is to attract *Sunday Engineers* from Shanghai. They are invited to Hangzhou on weekends, to offer consulting and technical service for the enterprises.

In regard to capitals, foreign capitals are introduced at large scales while financial innovations, which are within limit of local authority, stimulate the domestic capitals. Regarding to new energy, new technology, and new materials the municipal government of Hangzhou has set up manufacturing bases, high-tech development zones and scientific research bases, which are in track with the world economy and attract many investors.

The municipal government of Hangzhou pays great attention to building industrial parks,¹³ collecting and reorganizing funds, land, human resources, and technology within the region. Industrial parks have become a very important means for the development of industrial economy. The park administration committee is a government agency with certain decision-making power on the economic management within the park. The committee offers services to foreign investors. For example, in the Xiasha Economic and Technology Development Zone in Hangzhou there are many high-tech enterprises such as Toshiba. If the enterprises apply to import equipment with advanced technology, they will get the approval very quickly. Whenever machinery is introduced, the park committee will immediately get into touch with the customs, and the Customs Hangzhou will be ready for service just like a fireman. In urgent cases leaders of the customs in the development zone will work overtime, waiting for approvals. They are so highly efficient that they are able to obtain the approval within one day. It only takes 30 minutes for export inspection and two to three hours for import inspection at the customs while it took 20 hours in the past. Work efficiency of the customs administration is an important issue that foreign

¹³ Industrial parks here refer to various economy and technology development zones, industrial zones with features, scientific economic zone and industry zone. The parks are unanimously planned, collected and organized for unanimous management.

investors take into account. In Hangzhou it has become an advantage for attracting more investors.

Summary

Generally speaking, the course of investment climate policy reform is always that of a game playing among interest groups. Through the historic and comparative analysis, we can draw the following basic conclusions.

First, investment climate reform is a long and repeating course. The strength of each group grows and declines at times. There are also changes of benefits within each group.

Second, the reform and open policy raised by the central government is a strong force in promoting the improvement of the investment climate in Hangzhou. Hangzhou would not be as such if there were no economic system reform with market tendency, no depth in opening, no policy of participating in the global economy, no globalization of the economy, and no rapid development of digitalization.

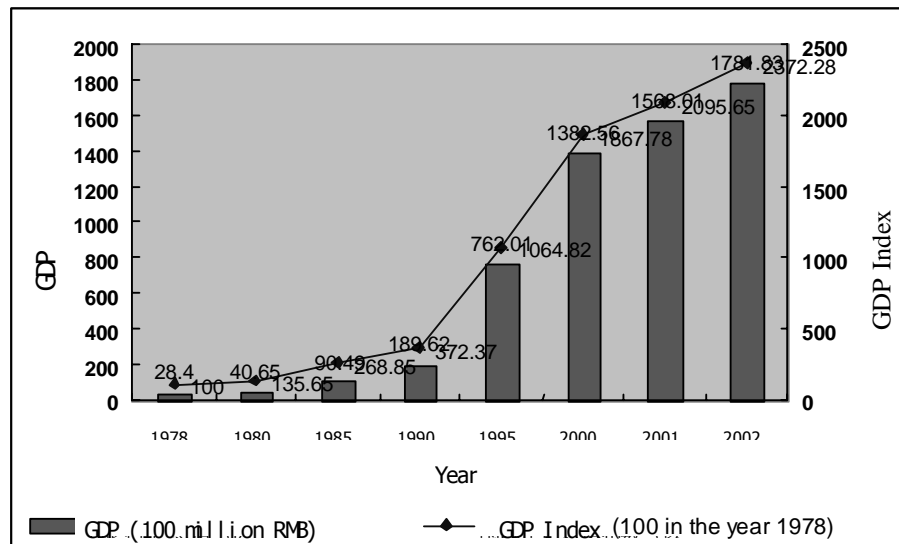
Third, the municipal government of Hangzhou was in a leading position in improving the investment climate. Its contributions cannot be covered up. It is because of the *focusing on certain tasks while putting others aside* policy¹⁴ that Hangzhou seized the opportunity during the important period, overcame challenges, made adjustments several times, and promoted further improvement of the investment climate.

Fourth, whether the investment climate is good or bad has a strong impact on the economic development of the region. The course of the gradual improvement of the investment climate in Hangzhou is that of the gradual enhancement of the overall economy. The GDP in Hangzhou was 178.183 billion RMB in 2002, which was 63 times of that in 1978. The fiscal revenue in 2002 was 25.714 RMB, which was 27 times of that in 1978. In 2003 the GDP in Hangzhou reached 209.2 billion RMB, with a growth rate of 15%; fiscal revenue reached 32.9 billion RMB, with a growth rate of

¹⁴ Generally speaking, at the stages of additional, stock and comprehensive reform, the municipal government changed itself from a *doing nothing government—government of management type—government of service type* when it was creating an investment climate. It should be pointed out that at the stage of additional reform, the municipal government in Hangzhou was actually not doing nothing in social management and economic regulation. It was strongly colored with planning and guiding functions, just as the governments in other regions did. Doing nothing mainly refers to its support on private sector for free development.

28.2%.

Chart 4. Change of GDP and its Index in Hangzhou



source: www.hzstats.gov.cn/data/nj2003/1/nj_.htm

Fifth, the investment climate is not unassailable. Instead, there exist some hidden anxieties together with opportunities for new changes. The following are examples: The comparative advantage based on factor endowment is not yet gained. The economic structure in Hangzhou is still in parallel with that in neighboring cities. There is a debate about whether Hangzhou should follow Suzhou to chase a high percentage of foreign capital. Suzhou was ahead of time in setting up industrial parks with large scale. Over the years the annual amount of foreign capital in Suzhou has been 8 to 10 times¹⁵ that in Hangzhou. To catch up with Suzhou, Hangzhou has set up many industrial parks of similar type with those in Suzhou. There are some drawbacks of projects that were blindly set up, with insufficient supply of coordinating facilities, repeated construction and surplus supply over demand. There are some different opinions among enterprises, they hold the view that Hangzhou should make use of its endowment in technology and resources, take advantage of commerce and R&D, strengthen cooperation with transnational corporations whose products are value-added and play a leading role in the industry chain, and enhance the quality and overall amount of private economy. They don't hope that the economy Hangzhou

¹⁵ In 2003 the newly registered foreign capital in Suzhou was 12.496 billion US\$, the foreign capital put in use was 6.8 billion US\$.

fosters is similar to that in Suzhou, i.e. with strong anticipation of the government, foreign capital pulling the economy, export-oriented and with labor-intensive manufactures.

The government service quality and consciousness of service in Hangzhou is lagging behind that in Suzhou. The comparative advantage is not outstanding and there exists blindness in project construction, so Hangzhou lacks advantage in fostering industry groups and supplying coordinating services. Let's take industrial park as an example. Though the service in Hangzhou is of high level, they still lack experience in supplying judicial service. It is an urgent task for Hangzhou to establish a legal environment that is adaptable to the unification of the global economy. It is also a severe test on the government to further changes of its role.

Impacts of the reform

In the World Bank report ranking the investment climate in 23 Chinese cities, Hangzhou was ranked first in comprehensive ranking. Centering on relevant indices of the World Bank report, we will make following descriptions about the impact of the investment climate reform in Hangzhou.

Hangzhou got the highest score in *market entry/exit index* (see Appendix Chart 1-3). This index shows the percentage of products that are produced in Hangzhou and sold in other provinces, and the percentage of redundant personnel in enterprises. We can find that the degree of locality protection in Hangzhou is very low and employment situation in enterprises is very flexible. Hangzhou got the fourth place in *labor market flexibility index* (see Appendix Chart 4). It not only shows low exit barriers, but also means that the enterprises are able to reduce the redundant personnel and enhance operation efficiency. This is one of the achievements that the municipal government of Hangzhou reduced its intervention in the market and supplied a loose environment for enterprises.

Hangzhou got the highest score in *informal payment index* (see chart 5), enterprises in Hangzhou only pay 0.007% of their turnover to the government as informal payment, which is 1/71 of the highest payment among the 23 cities. In correspondence to the informal payment, enterprises in Hangzhou enjoy more healthy financial services than those in other cities, and they do not rely on informal payment in obtaining loans (Hangzhou also got the highest score in *financial service index*, see Chart 6-8). The financial service sector in Hangzhou has been in a fine circle. Enterprises that obtain loans in a formal way have higher production efficiency and better ability to return the

loan than those who obtain loans by informal payments, in this way stable profits rush to the financial service sector¹⁶.

Though Hangzhou has made remarkable achievements, it still has some gaps in certain aspects, which we can find from what is mentioned above. They have become important contexts for investment climate reforms. With the following improvement, the investment climate in Hangzhou will be further enhanced.

Hangzhou was ranked medium in the *international unification index* (see Appendix Chart 9-10). The index includes two types of data: percentage of foreign proprietorship and enterprises with foreign cooperators. Though there is a gap, we can still find that over the recent years, especially after China's entry into the WTO in 2001, Hangzhou has made progress in attracting foreign capitals and open to the outside. Foreign capital that is promised in agreement in 2003 is double of that in 2002, and is four times of that in 1998 (see Table 3).

**Table 3: Direct foreign investment over
the past six years (unit: ten thousand US\$)**

Year	Number of projects	Total investment in agreement	Foreign capital in agreement	Foreign capital put to use
1998	216	98219	51400	38425
1999	212	83416	56742	42025
2000	315	89781	64548	43093
2001	483	154447	103023	50324
2002	587	247888	96720	52186
2003			20010	

Source: <http://www.hzstats.gov.cn/data/nj2003/8/nj-.htm>

The time to try a case is the most effective parameter to judge the efficiency and usefulness of the judicial system, but Hangzhou was ranked No. 4 from the bottom among the 23 cities (see Chart 3). Judicial efficiency is one of the important indices to judge the government's efficiency, it does not match with the achievements that Hangzhou has made in the reduction of informal payment and in the promotion of

¹⁶ The rate of non-performing loans of the banks in Hangzhou is only 4%. It still keeps declining. By the end of June 2003, the rate of non-performing loan of the four main banks in China was 22.9%.

transparency of government affairs. Though the judicial system is inefficient and the law system is incomplete, Hangzhou still effectively pushes the reform of the economic system. It should be noted that over 20 years, especially during the stage of additional reform, the growth of the market economy in Hangzhou comes, to a large extent, from the release and extension of the traditional market economic forces. It is not based on the legal and supervision framework under the modern market economy. The inefficiency of judicial system has become a main systematic barrier. To accelerate the adjustment and reform of the judicial system will undoubtedly push the improvement of the investment climate in Hangzhou.

Appendix:

Chart 1: Comparison of market wideness among cities

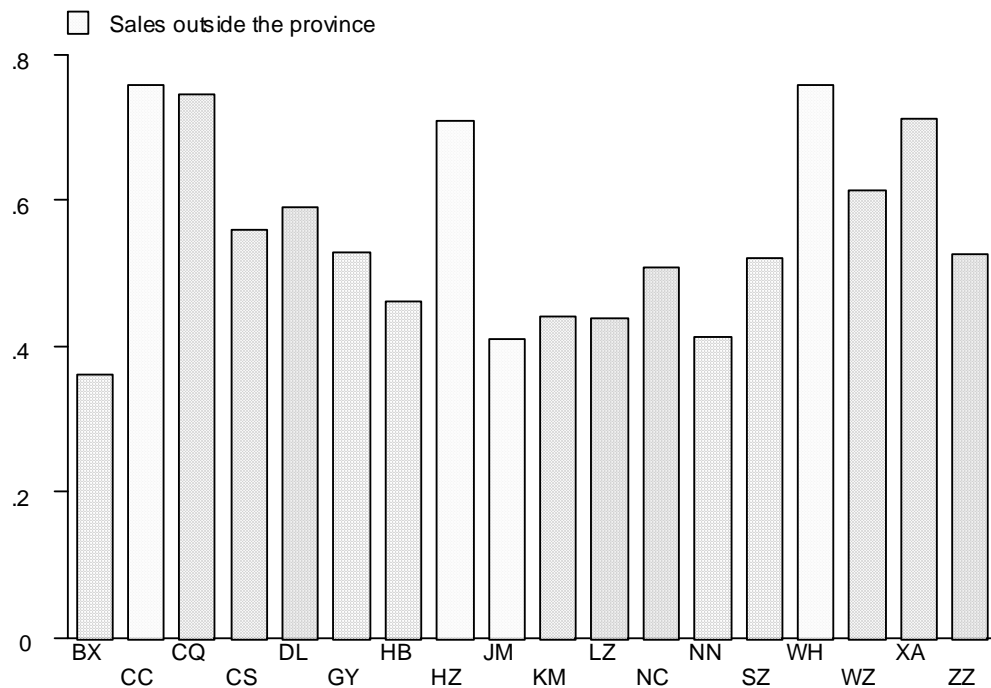


Chart 2: Comparison of productive forces among cities

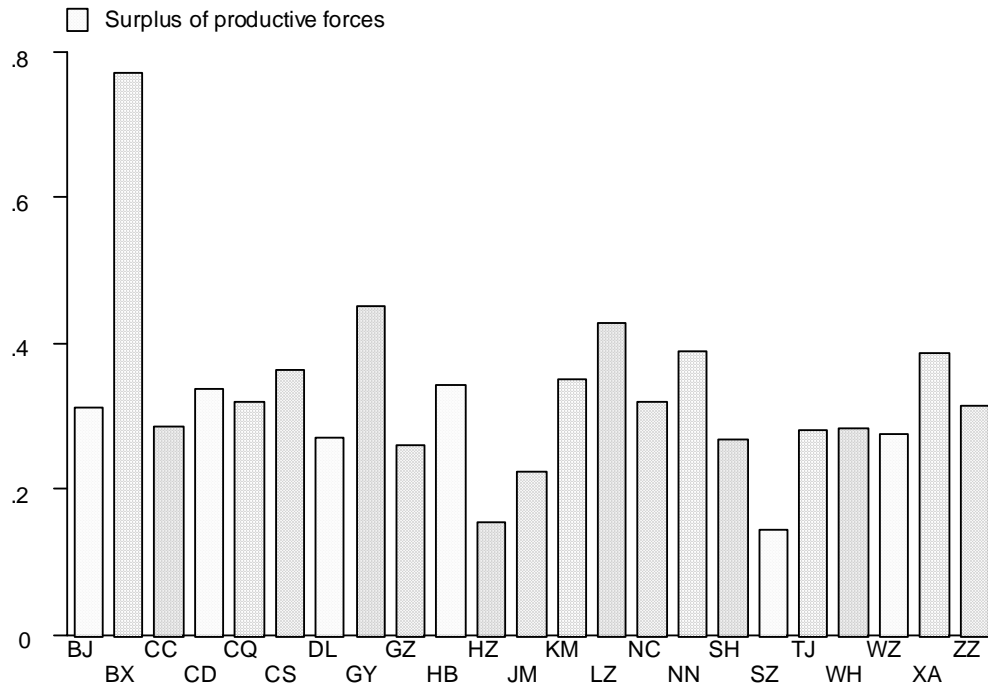
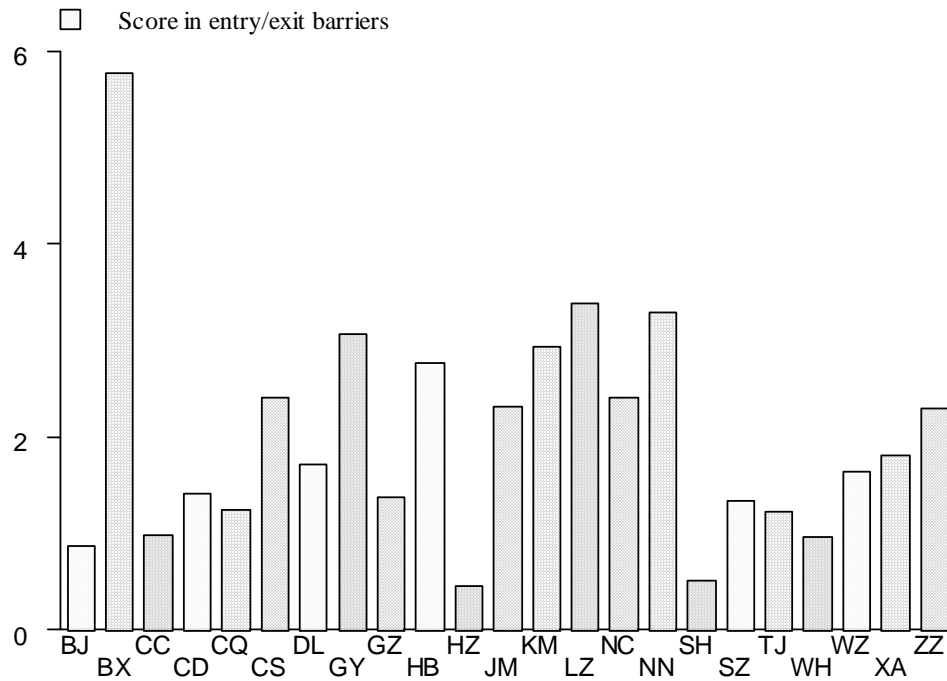


Chart 3: Score in barriers to entry/exit



Note: BX=Benxi, BJ=Beijing, CC=Changchun, CD=Chengdu, CQ=Chongqing, CS=Changsha, DL=Dalian, GY=Guiyang, GZ=Guangzhou, HB=Haerbin,

HZ=Hangzhou, JM=Jiangmen, KM=Kunmin, LZ=Lanzhou, NC=Nanchang, NN=Nanjing, TJ=Tianjin, SH=Shanghai, SZ=Shenzhen, WH=Wuhan, WZ=Wenzhou, XA=Xi'an, ZZ=Zhengzhou.

Chart 4: Comparison of labor policy among cities

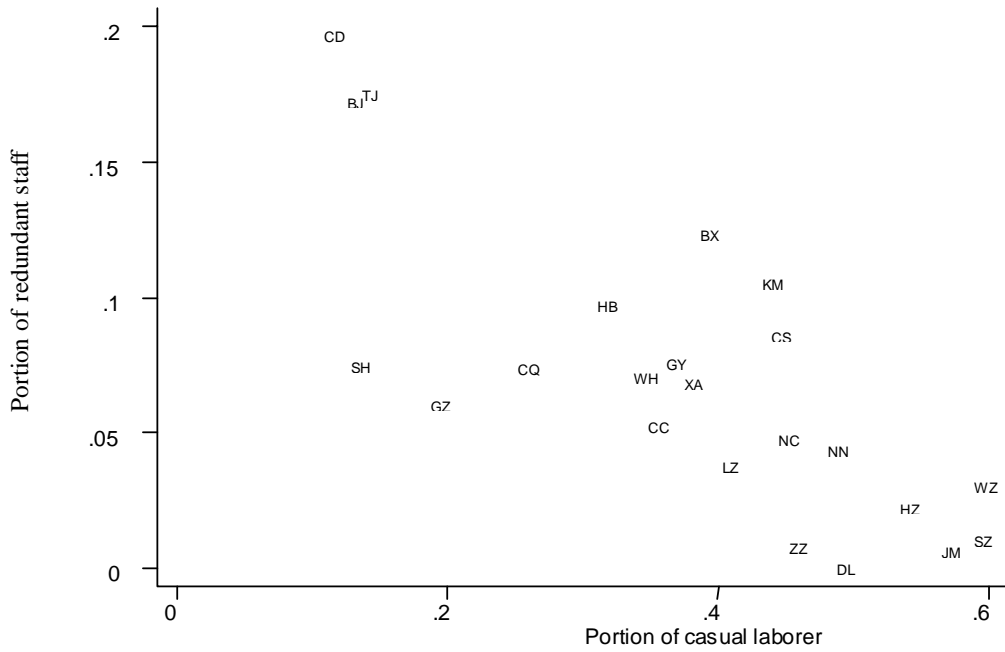


Chart 5: Informal payment

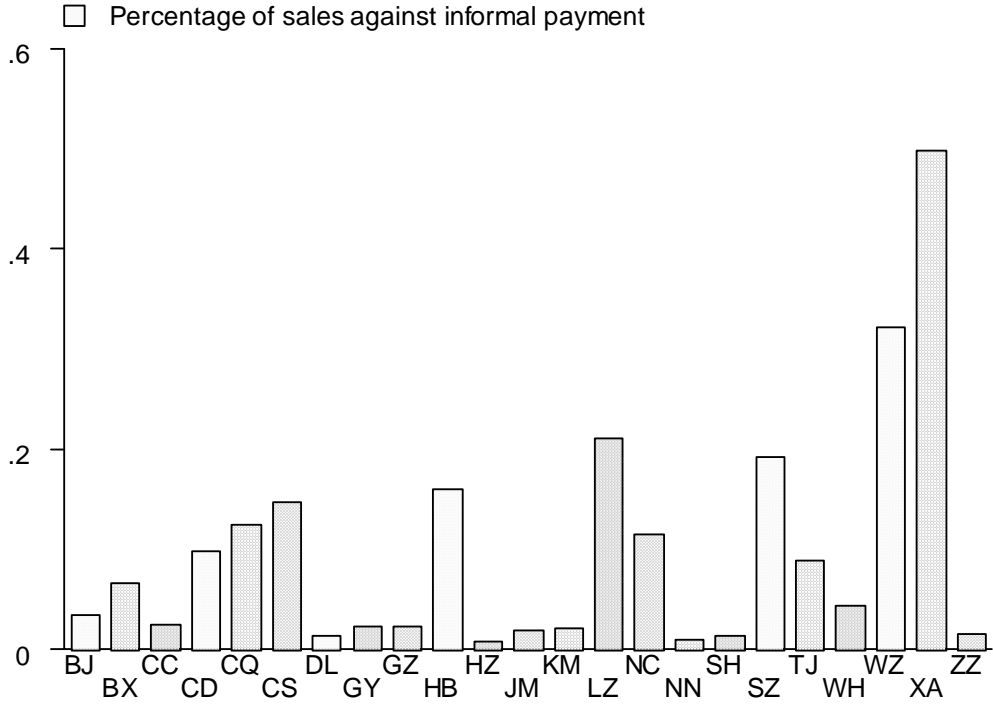


Chart 6: Access to finance

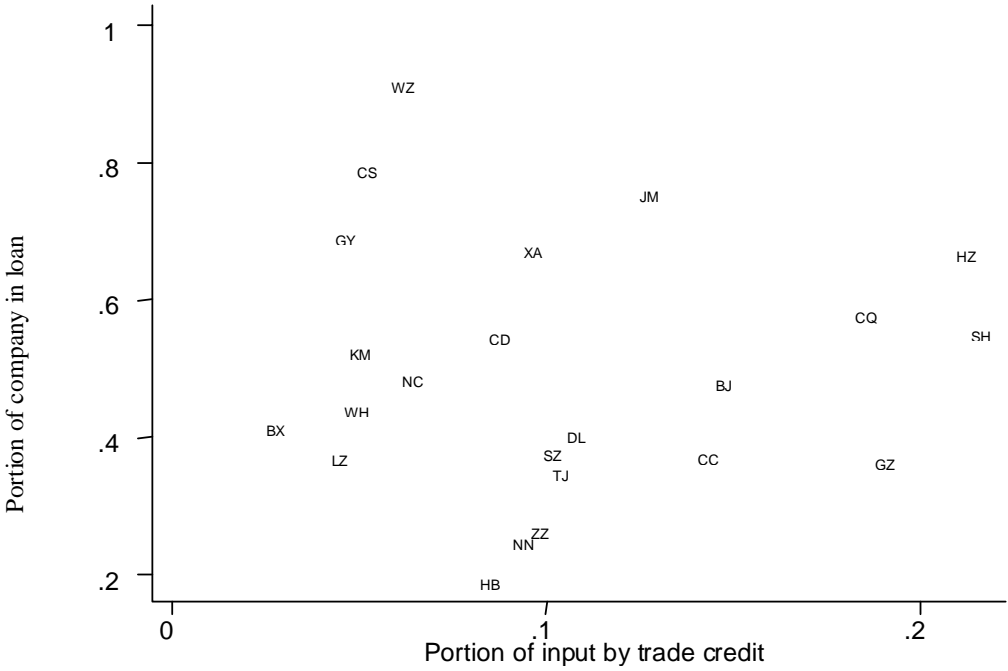


Chart 7: Portion of companies gaining loans by informal payment

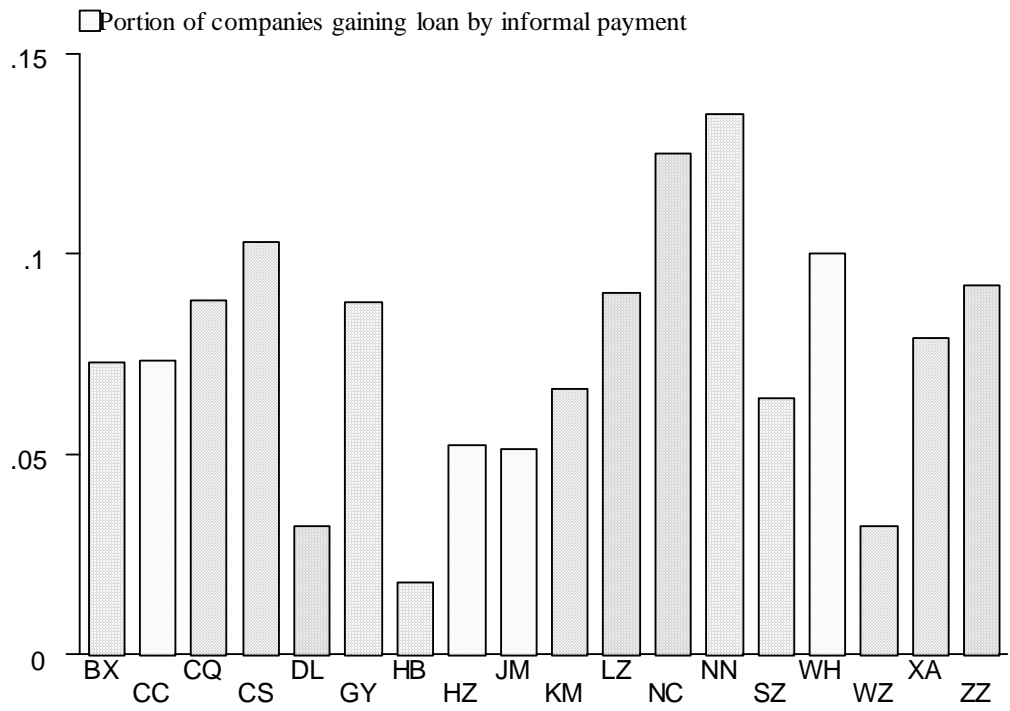
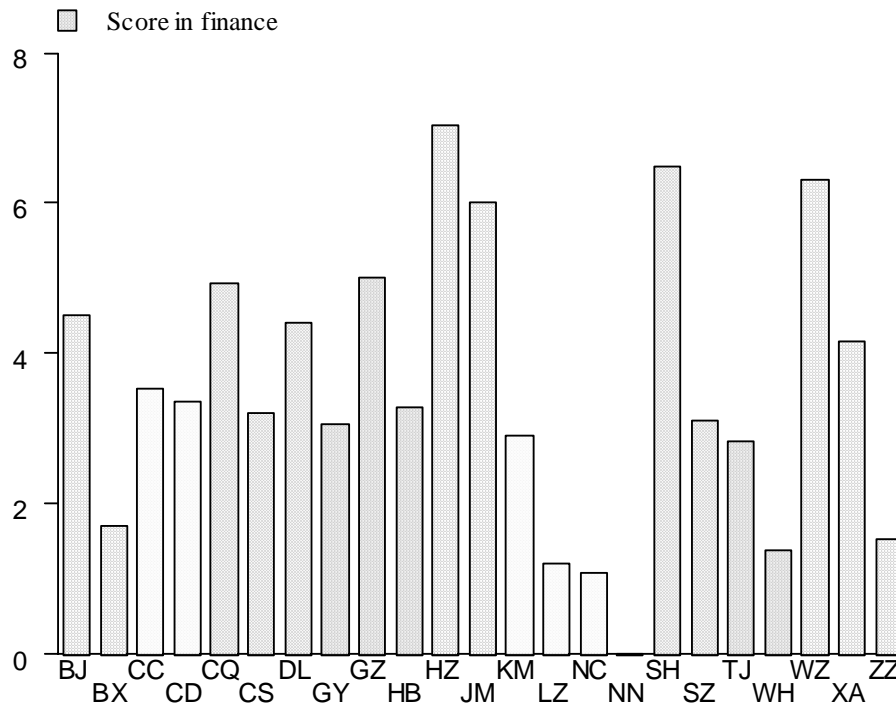


Chart 8: Score in finance¹⁷



Note: For a clearer look at the chart, a constant is added to the financial score.

BX=Benxi, BJ=Beijing, CC=Changchun, CD=Chengdu, CQ=Chongqing,

CS=Changsha, DL=Dalian, GY=Guiyang, GZ=Guangzhou, HB=Haerbin,

HZ=Hangzhou, JM=Jiangmen, KM=Kunmin, LZ=Lanzhou, NC=Nanchang,

NN=Nanjing, TJ=Tianjin, SH=Shanghai, SZ=Shenzhen, WH=Wuhan, WZ=Wenzhou,

XA=Xi'an, ZZ=Zhengzhou.

¹⁷ Three norms are applied in weighting the function of the financial market: whether enterprises can obtain loan from regular banks (in one year of the three year term), obtain funds by credit transaction, and obtain loan by paying informal fees to banks.

Chart 9: Comparison of internationalization among cities

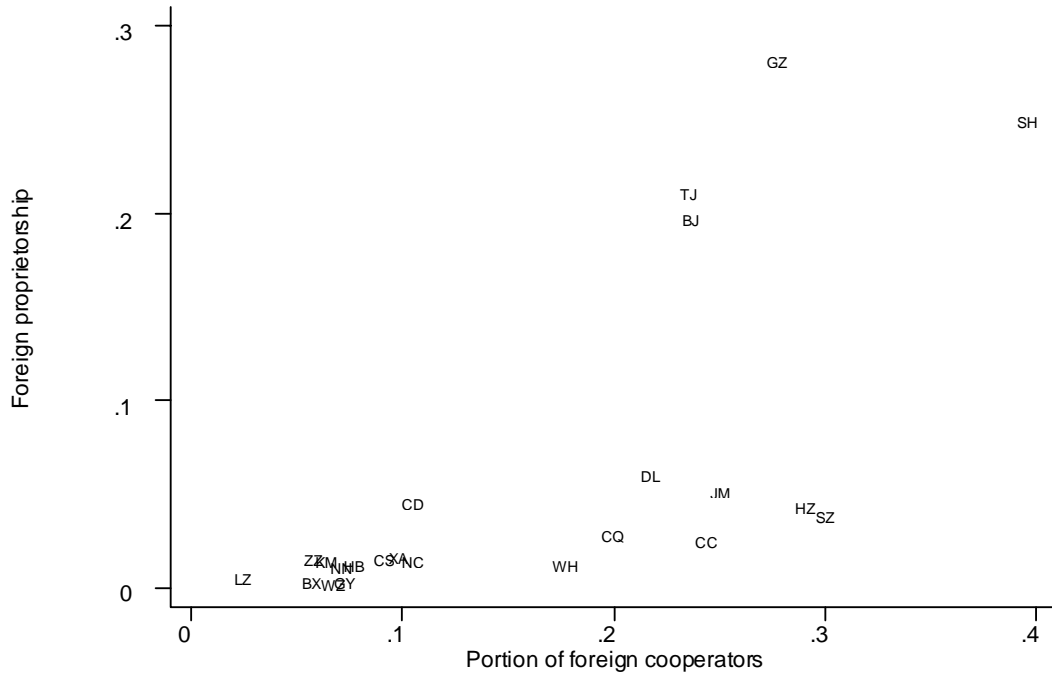
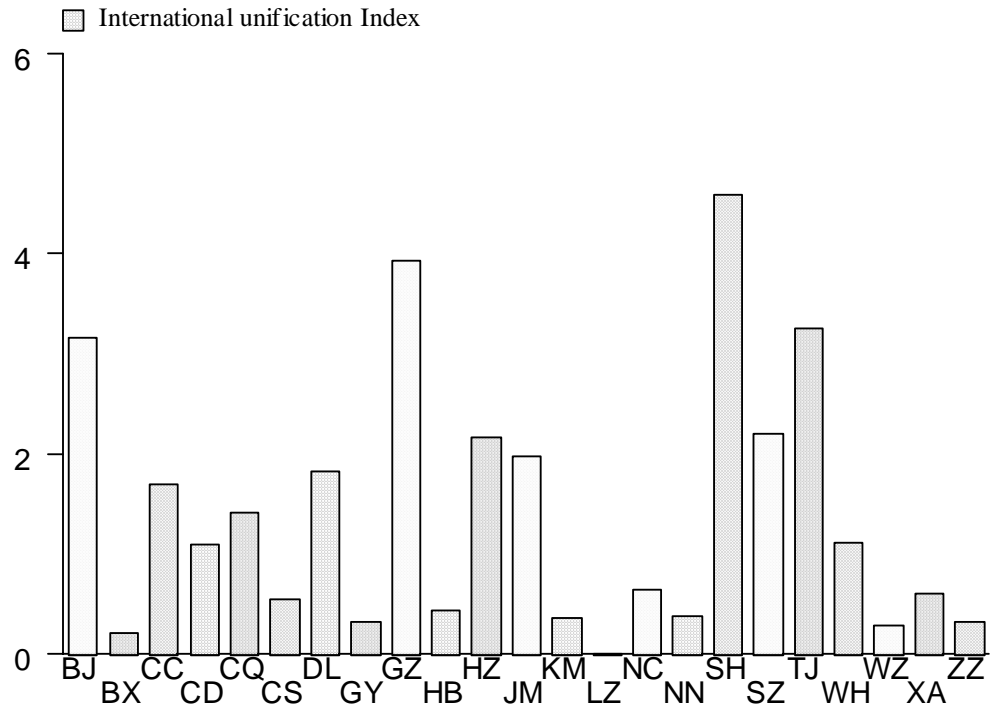


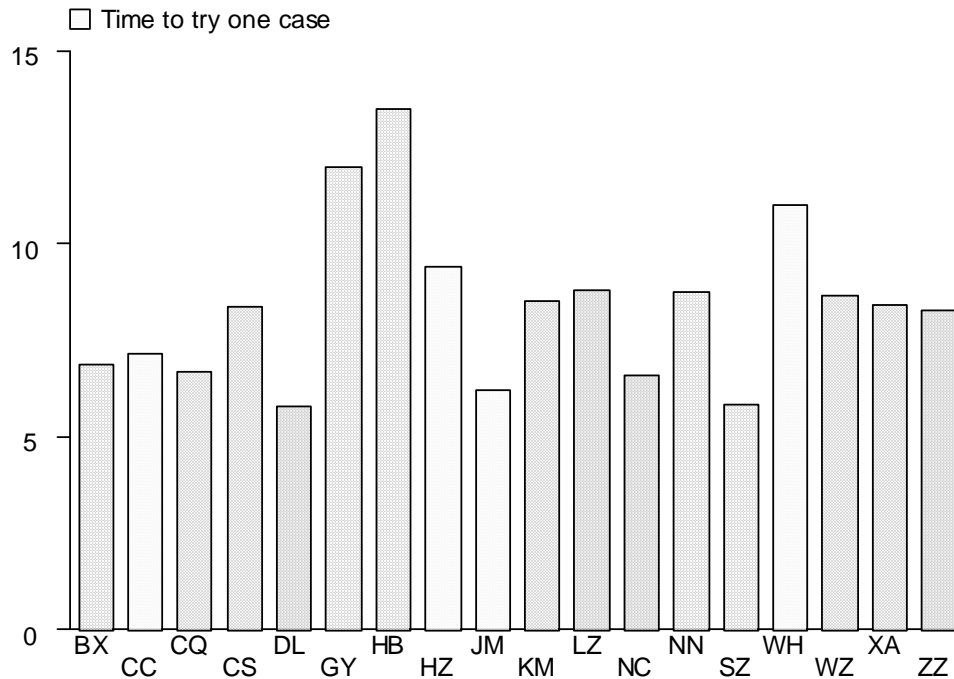
Chart 10: International unification Index



Note: BX=Benxi, BJ=Beijing, CC=Changchun, CD=Chengdu, CQ=Chongqing,

CS=Changsha, DL=Dalian, GY=Guiyang, GZ=Guangzhou, HB=Haerbin, HZ=Hangzhou, JM=Jiangmen, KM=Kunmin, LZ=Lanzhou, NC=Nanchang, NN=Nanjing, TJ=Tianjin, SH=Shanghai, SZ=Shenzhen, WH=Wuhan, WZ=Wenzhou, XA=Xi'an, ZZ=Zhengzhou.

Chart 11: Time for trial by the court (unit: month)



References:

David Dollar, Anqing Shi, Shuilin Wang, and Lixin Colin Xu, (Improving City Competitiveness through the Investment Climate: Ranking 23 Chinese Cities, Worldbank working paper, 2003)

Zhou Li, Yifu Lin (China Economy, China Financial and Economic Publishing, 2003)

Relevant laws and regulations, government documents, speeches of leaders and statistics.

www.hangzhou.gov.cn; www.invest.gov.cn