

Better Policies Series

# ENABLING CHINA'S TRANSITION TOWARDS A KNOWLEDGE-BASED ECONOMY

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# FOREWORD

With the adoption of the 13th Five-Year Plan in March 2016, China entered a decisive phase of building the “moderately prosperous society” it envisions for 2020, which will mark a critical milestone in realising the “Chinese Dream”. The Chinese government recognises that the old growth model is no longer sustainable and has crafted a comprehensive reform roadmap to move the economy towards a path of more balanced, sustainable and inclusive growth. More emphasis has been placed on innovation as a key driver of economic performance and social progress, as new sources of growth will increasingly stem from emerging technologies, and the digital economy offers new opportunities to spur efficiencies, reorganise production and improve services across all facets of life. This focus on innovation should help increase total factor productivity growth, long-term growth potential and the pace of income convergence with OECD countries. Innovation is also key to ensuring a wider spread of the benefits of growth across society and a greener development model.

The evidence of OECD countries over the past decade reveals that the diffusion of innovation within and across economies plays an essential role in ensuring higher and more inclusive productivity growth. China must step up its efforts to facilitate knowledge spillovers by promoting global connectedness. At the same time, it must continue to further advance the technological frontier through investment in knowledge-based capital.

Boosting innovation also paves the way for achieving the G20’s objective of 2% upside growth. The OECD is proud of its co-operation with China on promoting innovation as a key driver to jump-start sluggish growth in the G20 economies. Under China’s G20 Presidency in 2016, the *G20 Blueprint of Innovative Growth* will bring together countries’ endeavours in the areas of innovation, the new industrial revolution and the digital economy in a set of shared principles of *Leadership, Partnership, Inclusiveness, Creativity, Synergy and Flexibility*.

This report has been prepared to support the round-table discussion convened by H.E. Premier Li Keqiang with the participation of the heads of leading international organisations. Based on the forthcoming 2017 OECD Economic Survey of China and other research, it presents five policy levers for the country to consider in its transition to an innovation economy and discusses how the OECD can support China in its reform process, through its instruments, its range of analytical tools and the collective experience of its member and partner countries.

Building on the past two decades of mutually beneficial co-operation with China, the OECD stands ready to join forces in enhancing the perspectives of the global economic recovery and looks forward to deepening this key partnership as China confronts the challenges of smoothly managing its multifaceted transformation. Given China’s importance for global economic developments, this collaboration is crucial not only for China and its people, but also for the rest of the world.



Angel Gurría

OECD Secretary-General



# TABLE OF CONTENTS

- China's transformation challenge..... 1
- Policy lever 1: Financial markets ..... 4
- Policy lever 2: Business environment..... 6
- Policy lever 3: Innovation framework ..... 8
- Policy lever 4: Education and skills..... 10
- Policy lever 5: Digital infrastructure ..... 12

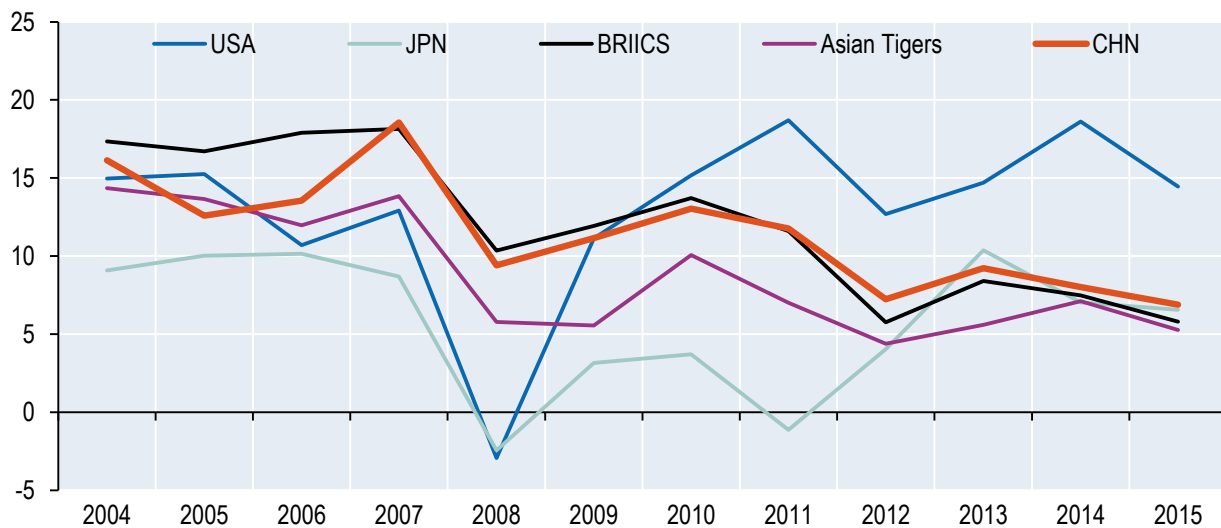




## CHINA'S OLD GROWTH MODEL IS NO LONGER SUSTAINABLE

Since the beginning of China's economic transformation in the early 1970s, investment has been a key driver of China's growth and has contributed to substantial improvements in living standards. Over three decades of average annual GDP growth of 10%, disposable incomes have soared, lifting hundreds of millions of people out of extreme poverty. The share of the population living in extreme poverty has declined from above 90% in the early 1980s to less than 10% today. However, this growth model is no longer sustainable. Returns on investment have declined, although they are still higher than those of the Asian Tigers (Figure 1). Excess capacity is plaguing several sectors (Figure 2), and negative externalities have been onerous, notably in terms of environmental degradation and income inequality. A key objective of the 13th Five-Year Plan (2016-2020) is therefore to move the economy towards a path of more balanced, sustainable and inclusive growth.

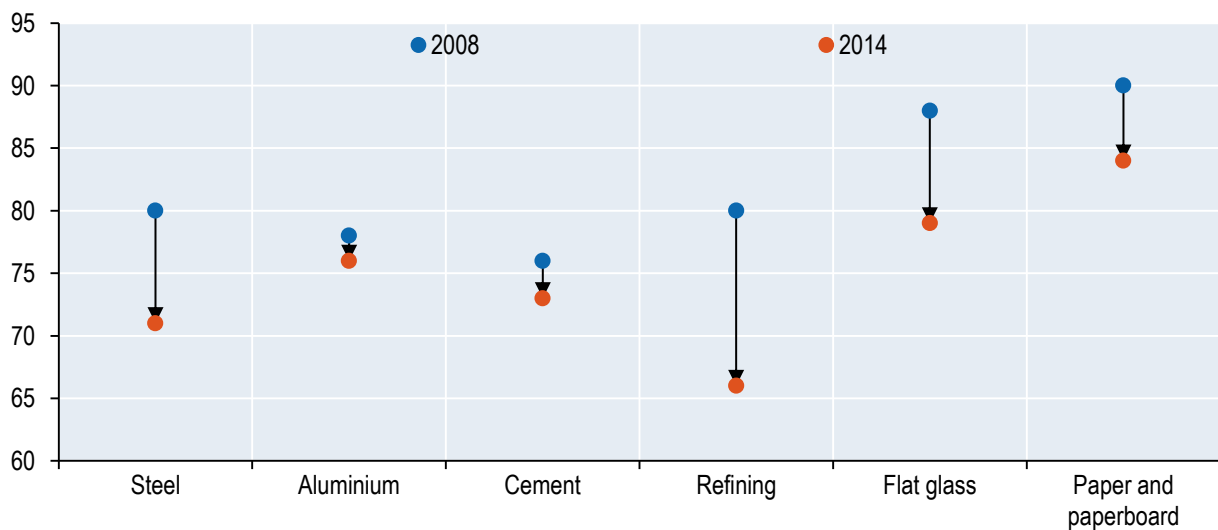
**Figure 1. The return on equity has come down**  
Return on equity, in %



Note: BRIICS = Brazil, Russia, India, Indonesia, China and South Africa

Source: OECD calculations based on Bloomberg.

**Figure 2. Excess capacity is plaguing several sectors**  
Capacity utilisation rate, in %



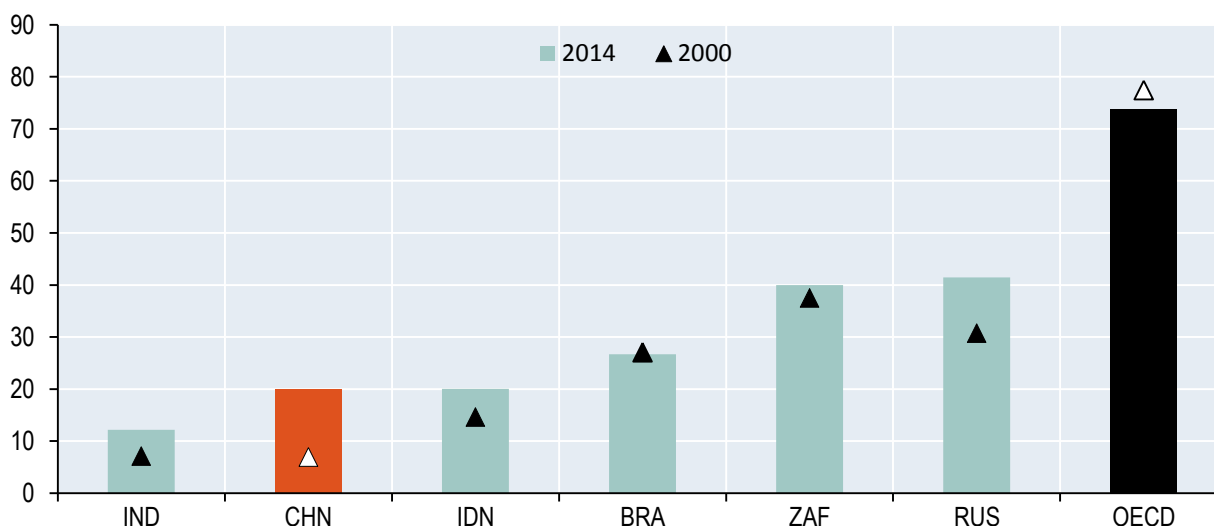
Source: EU Chamber of Commerce in China.



## CHINA NEEDS TO CONTINUE SUPPORTING PRODUCTIVITY GROWTH

Income convergence has been rapid, with China on track to become a high-income country by 2020. This process has been aided by strong productivity convergence in both manufacturing and services. However, the level of productivity remains a fraction of that in the United States (Figure 3). To pursue the catch-up and avoid the so-called middle-income trap, China should boost its long-term growth potential, placing more emphasis on innovation as a key driver of economic performance. This should help lift total factor productivity growth, which has fallen in recent years (Figure 4). An emerging confluence of technologies (e.g. 3D printing, advanced robotics, the industrial Internet and new bio- and nano-technology materials) could constitute a new industrial revolution, with the potential to spur a step change in how production occurs and opportunities for China to further embed sustainable and inclusive elements into its growth strategy. The digital economy also has wider implications, reshaping economies and offering new ways to create efficiencies and improve services across all facets of life. The 13th Five-Year Plan and the National Innovation-driven Development Strategy Outline recognise the crucial role of innovation and aim to make China an innovative economy by 2020.

**Figure 3. Despite significant progress, productivity in China remains a fraction of that in the United States**  
GDP per person employed, as a percentage of the US, constant 2010 PPPs



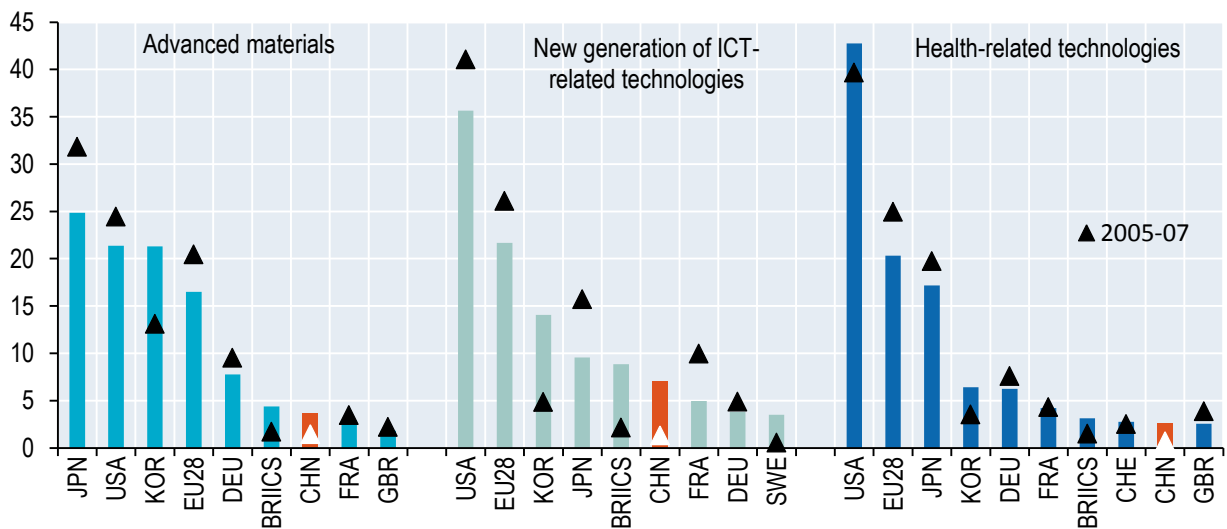
Source: OECD Productivity Compendium 2016.



## THIS REQUIRES FURTHER INVESTMENT IN KNOWLEDGE-BASED CAPITAL

Actions on innovation, the new industrial revolution and the digital economy are at the heart of the expansion of China's knowledge-based capital (KBC) – intangible assets ranging from data and patents to firm-specific skills – and can transform existing industries and forge new ones. Available data for G20 countries show that investment in KBC is an important component of overall business investment. Studies have shown that business investment in KBC contributes 20%-34% of average labour productivity growth and that countries that invest more in KBC are also more effective in reallocating resources to innovative firms. China is closing the gap with advanced countries in its R&D investments, spending 2.05% of GDP on R&D in 2014, compared to 2.9% in Germany and 2.7% in the United States. It is also making inroads in the disruptive technologies that underpin much innovation for the new industrial revolution and the digital economy (Figure 4). While still lagging behind Japan, Korea and the United States, China's share of patents filed in advanced materials, new generation ICT-related technologies and health-related technologies has increased recently, in contrast to countries such as France and Germany that saw their shares drop. These technologies, which hold significant potential for upgrading traditional manufacturing sectors and opening up new niches, are already being used by Chinese firms. China is also a growing player in the global digital economy. The Internet of Things and big data are flourishing and providing the basis of success for Chinese Internet companies such as Baidu, Alibaba and Tencent. But while China is clearly moving in the right direction, further efforts are needed to realise its ambition to become an innovation economy. Five policy levers are particularly promising in this regard: financial markets, the general business environment, the innovation framework, education and skills, and digital infrastructure.

**Figure 4. China is making inroads in disruptive technologies**  
Percentage share of IP5 patent families filed at the US and EU patent offices, 2010-12



Sources: OECD calculations based on Intellectual Property Office (IPO) (2014), *Eight Great Technologies: A summary of the series of patent landscape reports*, IPO, Newport, United Kingdom and OECD-STI Micro-data Lab, *Intellectual Property Database*.

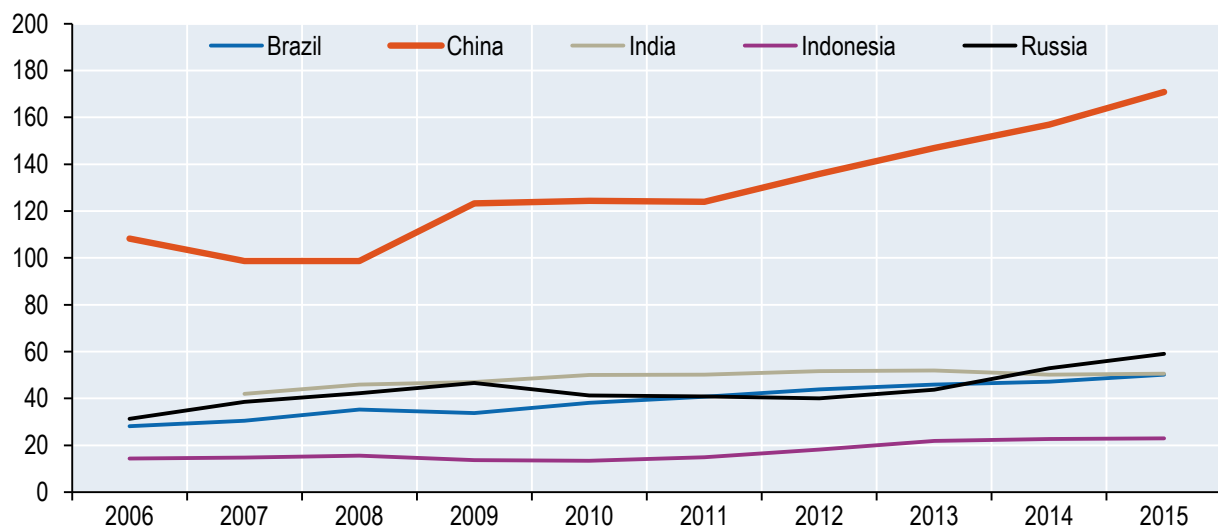
# POLICY LEVEL 1: FINANCIAL MARKETS



## ALLOWING THE MARKET TO PRICE CREDIT RISK WILL HELP IMPROVE RESOURCE ALLOCATION

The cost of capital has been low in recent decades, as a lack of market forces in pricing and allocating capital led to widespread misallocation. Coupled with the long-standing practice among government officials of viewing output growth as the sole performance indicator, this created a bias towards investment to expand production capacity. In the process, local officials competed to attract investment by offering low-cost or free land, cheap credit, tax concessions and other subsidies. At the same time, Local Government Financing Vehicles channelled large amounts of borrowed money to investment. Corporate leverage by state-owned enterprises soared, and the burden grew, amid falling returns and rising real interest rates in the industrial sector – driven by deflation, excess capacity and weak demand. From 2006 to 2015, corporate debt rose by 60 percentage points, to over 160% of GDP (Figure 5). For China's transition to a more knowledge-based economy, it is important to allow the market to play a greater role in allocation of resources and pricing of production factors. With these implicit government guarantees to public borrowers, private businesses (especially smaller businesses) were crowded out of the formal market and had to resort to retained earnings or informal borrowing to finance their activities. Since the recent revision of the Budget Law, local governments are no longer allowed to provide explicit or implicit guarantees to other entities, including Local Government Financing Vehicles. Another concern is the repeated rescue by policy makers of both corporate and non-corporate borrowers. Allowing orderly defaults of enterprises would facilitate the pricing of risk and enable a more efficient allocation of resources, by avoiding trapping valuable resources in non-viable firms.

**Figure 5. Corporate debt has soared**  
Corporate debt, % of GDP

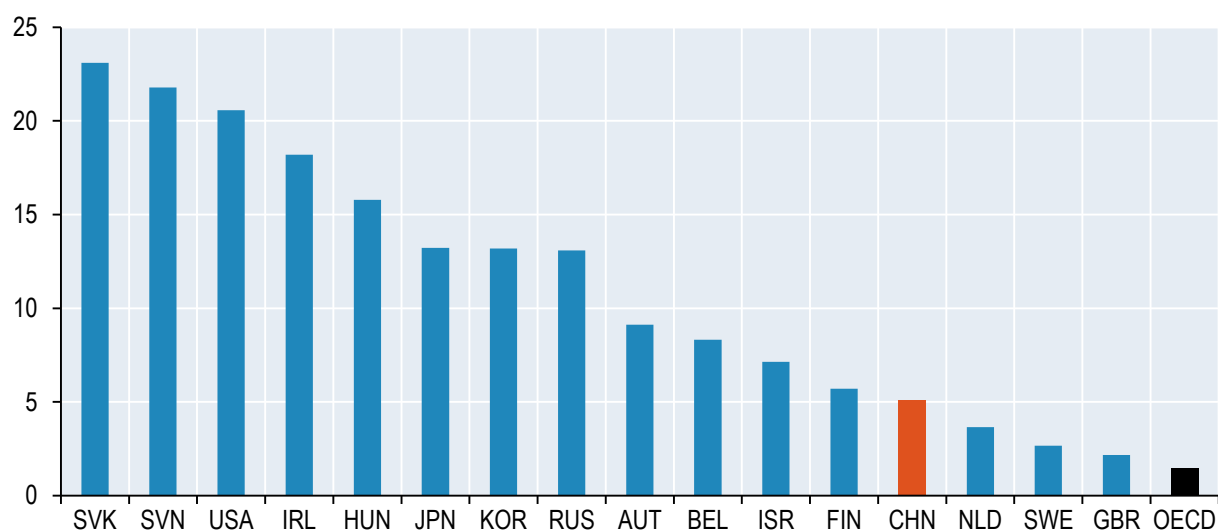


Sources: Bank of International Settlements.

## SOURCES OF CORPORATE FINANCING NEED TO BE FURTHER DEVELOPED

China's financial system is predominantly bank-based, with around 70% of new financing in 2015 coming from banks. While the sector remains heavily dominated by China's large four state-controlled institutions, recent government reforms, such as the licensing of new private banks, are likely to heighten competition. In addition, further development of non-bank funding sources is necessary to meet the needs of the innovative and service-based firms being promoted under China's 13th Five-Year Plan. Young innovative firms often have difficulty accessing financing in a bank-based financial system, because they have limited internal funds or collateral and do not have a proven track record. As a remedy, small and medium-sized enterprises (SMEs) in China tend to provide financing support to one another or to seek financing from the shadow banking system – at much higher interest rates than within the formal financing system (in 2015, the interest rate gap was more than 11 percentage points). Alternative financing instruments are progressively gaining in importance. Internet financing platforms, such as peer-to-peer finance, microfinance and crowdfunding, have grown rapidly in recent years. So have factoring and leasing. Similarly, China's equity and corporate bond markets have begun to play a larger role in financing firms. Avoiding overly restrictive rules on new listings and foreign ownership and ensuring strong regulation of insider trading and corporate governance will help these markets develop further. This should also strengthen the exit channels for venture capitalists, a key source of financing for innovation (Figure 6). International and Chinese experience suggests that the most successful model for government support to private venture capital is government co-financed hybrid venture capital arrangements in which the government invests passively as a limited partner, with capped returns in funds focused on neglected market segments.

**Figure 6. Venture capital is expanding, but growth rates fall short of the best-performing countries**  
Average annual growth rate, 2010-14



Note: 2010-13 for Japan.

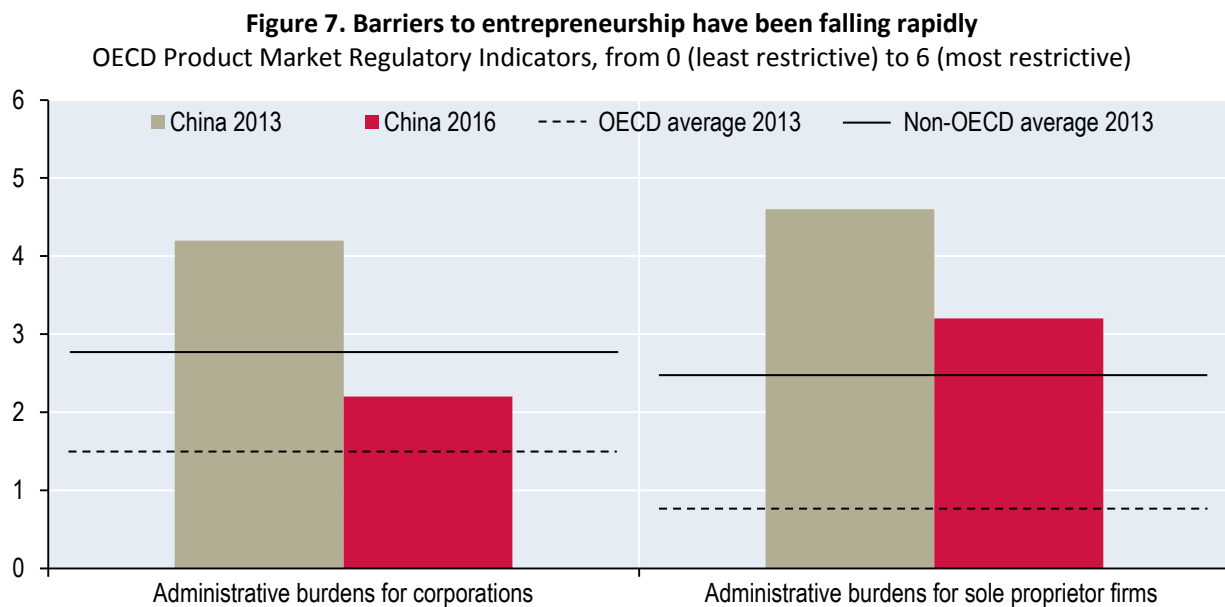
Source: OECD (2016), *Financing SMEs and Entrepreneurs 2016: An OECD Scoreboard*, OECD Publishing, Paris.

# POLICY LEVEL 2: BUSINESS ENVIRONMENT



## A WELL-DESIGNED REGULATORY ENVIRONMENT CAN HELP SPUR INNOVATION

The institutional environment for entrepreneurship and innovation has long been less supportive in China than in OECD countries. However, it has improved in recent years. A path-breaking achievement has been the removal of some barriers to entrepreneurship. The OECD Product Market Regulation Indicators highlight that since 2013, administrative procedures have been simplified and licensing requirements significantly reduced for both corporations and sole proprietor firms (Figure 7). Reduced barriers to business creation have led to an unprecedented surge in new company registration in the past few years, in particular in the service sectors. As argued in the forthcoming 2017 OECD Economic Survey of China, once a favourable environment is established for enterprise creation, it is also crucial to ensure that zombie companies do not take up resources, but exit the market through efficient mechanisms. Such creative destruction is a key driver of productivity growth by providing space for new ideas, new products and new processes. In addition, China should make further efforts to boost competition in network sectors, in particular in telecommunications, where innovation by smaller firms is inhibited as they have no access to the major Internet platforms owned by a few large enterprises.

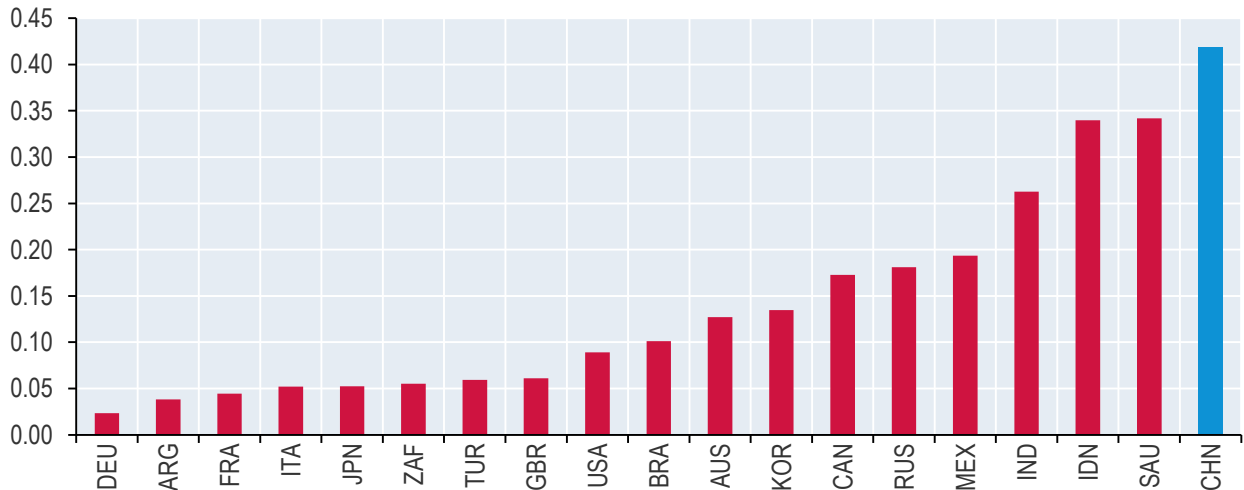


Source: OECD Product Market Regulation database.

## GREATER OPENNESS TO FOREIGN TRADE AND INVESTMENT CAN FOSTER KNOWLEDGE SPILLOVERS

The ability to learn from the global technology frontier is stronger in economies that are more connected with the frontier. OECD evidence suggests, for example, that the gain in annual productivity growth from a 2% acceleration in productivity growth in the frontier economy is one-third higher in countries that trade very intensively with that economy. China has made immense progress in opening up towards international trade and investment over the past decades. According to the OECD Foreign Direct Investment (FDI) Regulatory Restrictiveness Index, China is among the countries that have most liberalised their statutory restrictions on international investment. But the situation still remains very restrictive for foreign investors (Figure 8). Foreign equity limits still apply in various sectors, and all proposed foreign investment projects must be submitted for screening and approval based on conditions related to net economic benefits to the Chinese economy. In particular, many service sectors remain partly off limits to foreign firms (Figure 9). Among the services most relevant for the digital economy, foreign investment is encouraged in computer services and engineering, but it is prohibited in broadcasting and subject to a number of conditions in telecoms, such as the need to partner with a government-owned enterprise to obtain a licence.

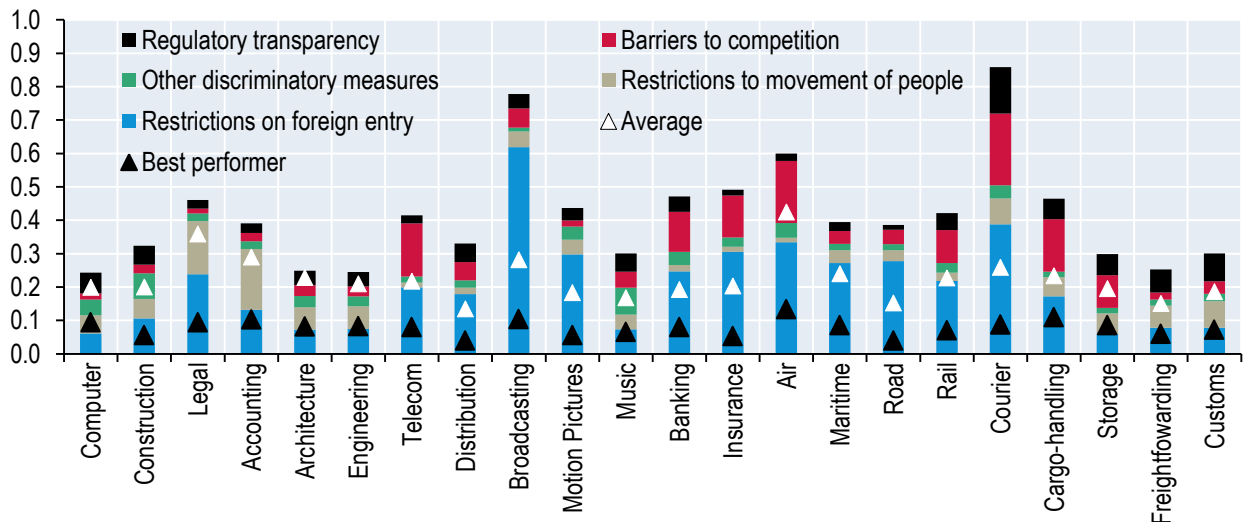
**Figure 8. China maintains a relatively restrictive regime for foreign investors**  
FDI Regulatory Restrictiveness Index, from 0 (open) to 1 (closed), 2014



Source: OECD FDI Regulatory Restrictiveness Index Database.

**Figure 9. China imposes relatively strong restrictions on trade in services sectors**

OECD Services Trade Restrictiveness Indicator (STRI), from 0 (least restrictive) to 1 (most restrictive), 2015



Source: OECD STRI Database.

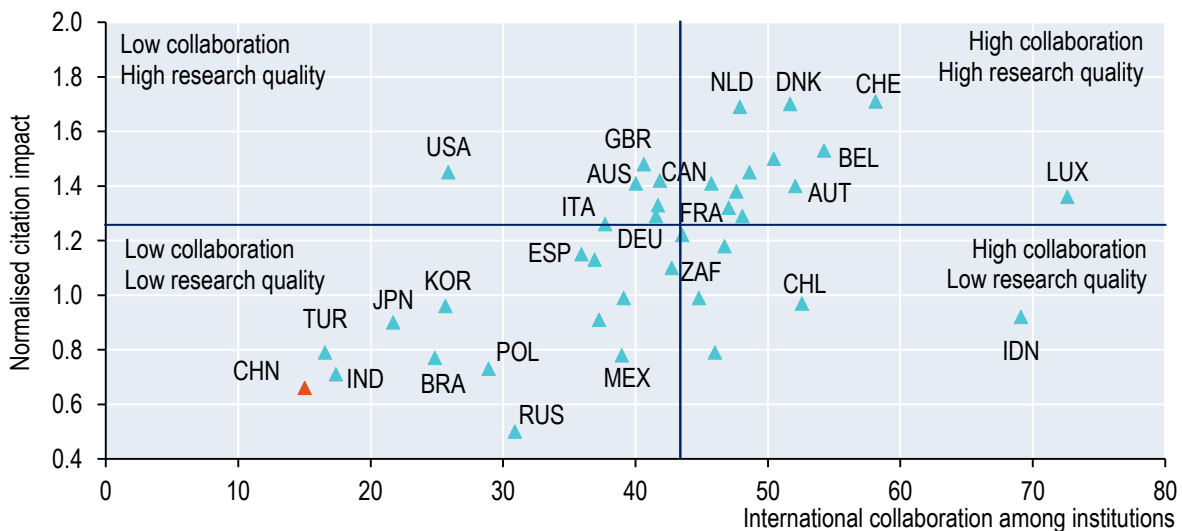


## GREATER INTERNATIONAL COLLABORATION CAN ENHANCE THE QUALITY OF CHINA'S RESEARCH

Collaboration within and across countries is a pervasive feature of research and innovation activities today. Single authors affiliated to a single institution account for less than 15% of scientific publications worldwide. Collaboration helps raise scientific quality and innovation capabilities by allowing authors to partner with leading experts elsewhere and share knowledge, costs and rewards (Figure 10). While vertical linkages with customers and suppliers are strong in China and sometimes contribute to innovative activities, most innovation stems from firms' own R&D. The first national-level manufacturing innovation platform, established in June 2016, aims to exploit potential synergies and complementarities across activities and to strengthen the link between development and commercialisation. International collaboration could be expanded by strengthening the regulatory framework for innovative activities in China, providing more incentives and legal guarantees to protect inventions. Knowledge circulation across borders can also be fostered through international mobility of highly educated individuals at different stages of their personal development and professional careers. For example, students in higher education who study or spend some time in a foreign tertiary-level institution build links with other individuals and acquire competencies that will be carried over to other places during their working lives. With respect to scientists who publish in peer-reviewed journals, China has reversed what was a net emigration of published scientists in the late 1990s into a significant net immigration of authors in the last few years.

**Figure 10. Greater researcher collaboration tends to be associated with higher quality research**

Normalised citation impact and percentage share of institutions that collaborate internationally, 2003-12



Note: The horizontal line shows the OECD average at 1.3 (normalised citation impact), and the vertical line shows the OECD average at 43.4 (international collaboration among institutions).

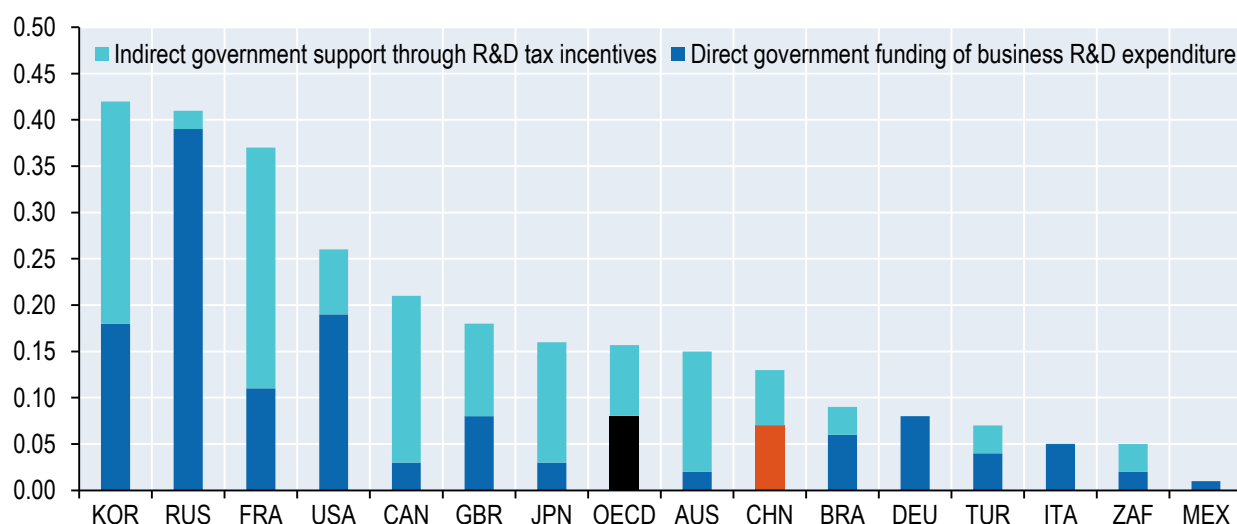
Source: OECD and SCImago Research Group (2015), *Compendium of Bibliometric Science Indicators 2014*.

## RAISING THE PRIVATE SECTOR SHARE OF R&D CAN HELP IMPROVE INNOVATION OUTCOMES

Chinese gross expenditure on research and development (GERD) has increased consistently over the last decade, from 1.22% of GDP in 2004 to 2.05% of GDP in 2014. OECD data suggests that countries with a higher share of GERD funded by the private business sector tend to have better innovation outcomes. Although the Chinese business sector accounts for 75% of China's GERD, the domestic private enterprise sector accounts for less than a third of this share. This partly explains why China's innovation performance is lagging behind. The government's call for Mass Entrepreneurship and Mass Innovation focuses on encouraging private sector investment in R&D and, more broadly, promoting innovation. Achieving this goal will require improvements in the general regulatory framework to strengthen competition (see Policy Lever 2) and improvements in conditions more directly linked to firms' innovation activities, in particular better protection of intellectual property rights (IPR). In this sense, China's recent increase in the number of courts handling IPR disputes and the launch of information-sharing platforms on IPR law enforcement are very welcome. In addition, China may consider stepping up government support for business R&D, which is currently below that of many other G20 countries (Figure 11), provided the support is well targeted and designed to overcome market and institutional failures. In the current context, it is important to ensure that private enterprises, especially young SMEs, are not put at a disadvantage relative to incumbents, for instance with respect to eligibility for R&D tax incentives and other government support measures.

**Figure 11. Government support for business R&D is lower than in many other G20 countries**

Direct government funding of business R&D and tax incentives for R&D, % of GDP, 2013



Sources: OECD R&D Tax Incentive Indicators and OECD Main Science and Technology Indicators.



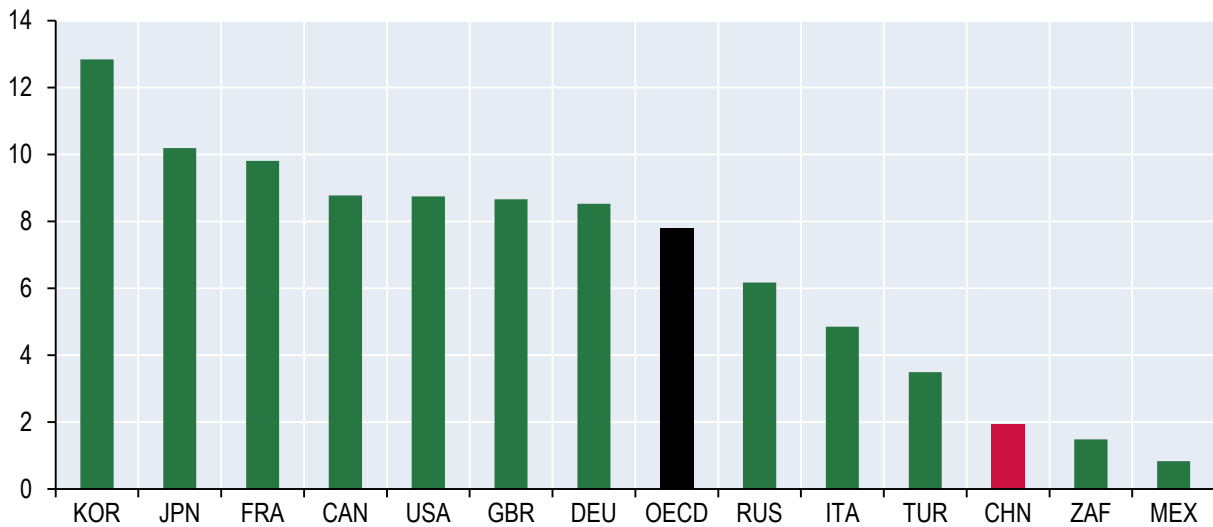
# POLICY LEVEL 4: EDUCATION AND SKILLS



## HIGH-SKILLED PEOPLE ARE A CRUCIAL ELEMENT OF AN INNOVATIVE ECONOMY

Innovation depends on people who have the knowledge and skills to generate new ideas and technologies, bring them to the market and implement them in the workplace, and who can adapt to structural changes across society. While basic competencies are generally considered important for absorbing new technologies, high-level competencies are critical for the creation of new knowledge and technologies. Emphasis is increasingly put on capabilities to adapt and combine multidisciplinary knowledge and solve complex problems. The acquisition of such skills starts at a very early age. The results of the OECD Programme for International Student Assessment (PISA) for Hong Kong, Macao and Shanghai suggest that Chinese students perform well very in maths and science, pointing to a good potential capacity to staff future knowledge-driven industries with home-grown talent. The challenge will be to replicate these results more widely in China and boost the pool of skilled workers, such as researchers, who still account for a relatively small share of employment (Figure 12). Moreover, according to OECD research undertaken for the forthcoming 2017 OECD Economic Survey of China, the country has acute skills shortages in the area of computer programming (Figure 13). Reducing this skills deficit will be a prerequisite for the widespread development of Internet-based industries as well as the success of China's Internet Plus Initiative.

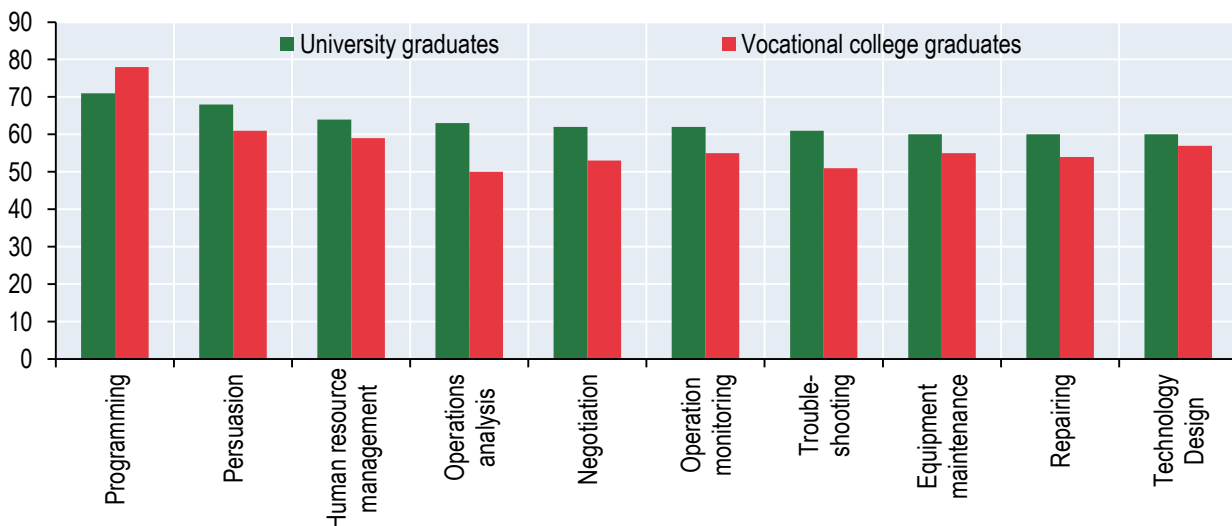
**Figure 12. China needs to expand its pool of researchers**  
Researchers per thousand workers, 2013



Source: OECD (2015), *OECD Science, Technology and Industry Scoreboard 2015*, OECD Publishing, Paris.

**Figure 13. Programming skills are falling short**

Percentage of students who have not acquired the listed skills even though they are needed for their job, 2013

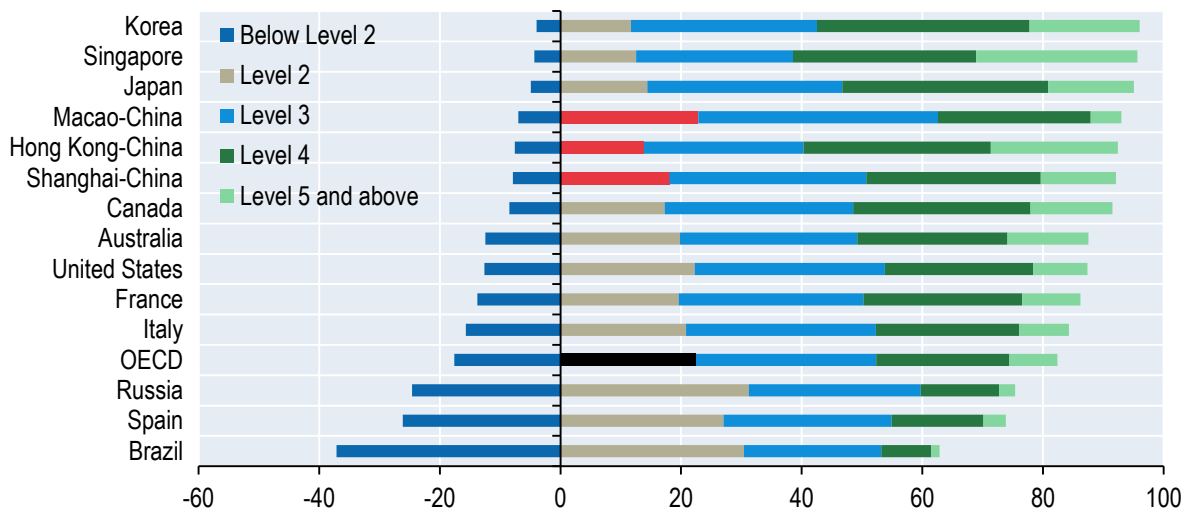


Source: OECD research based on MyCOS survey data.

## MANY CHINESE STUDENTS ARE ONLINE, BUT SOME ARE DIGITALLY ADRIFT

The digital economy requires people to be able to use and embrace digital products, particularly the Internet. The OECD's 2012 PISA study set out to discover how well students are able to read, navigate and understand online texts. Some of the best-performing economies in the PISA assessment of online reading include Macao, Hong Kong and Shanghai (Figure 14). Top performing students in digital reading are able to evaluate information from several sources, assessing the credibility and utility of what they read. But there is more to digital reading than deciphering and comprehending text. PISA 2012 also created a simulated browser environment to assess students' web-browsing behaviour. On average, students in Singapore rank highest for the quality of their web-browsing behaviour, followed by students in Australia, Korea, Canada and the United States (Figure 15). In both Macao and Shanghai, as many as one in five students visited more pages that were irrelevant to solving the given task than relevant pages. While these students are persistent in their efforts to solve the task, they are digitally adrift.

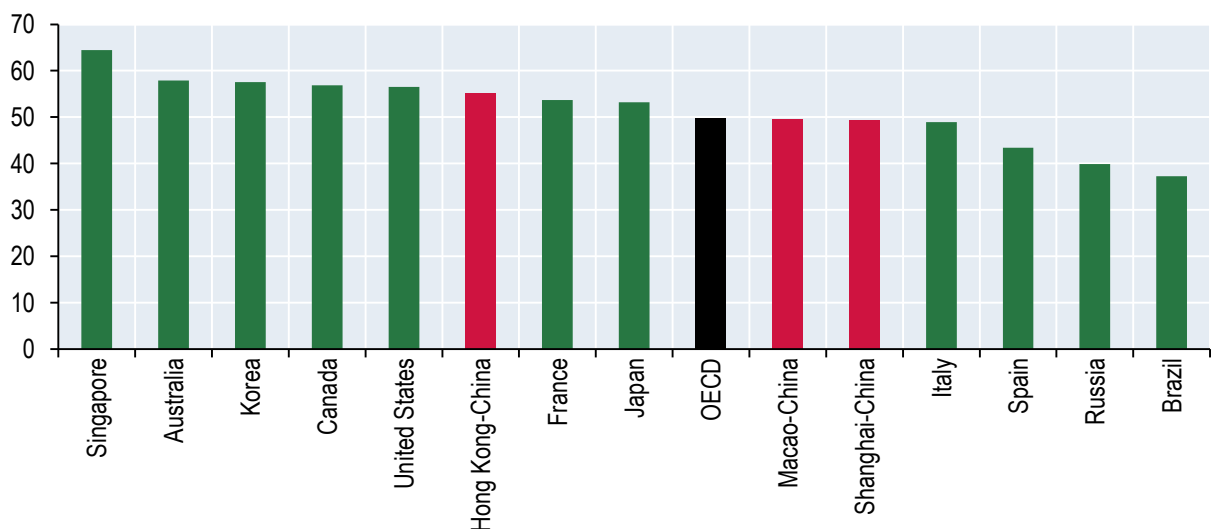
**Figure 14. Most Chinese students in Hong Kong, Shanghai and Macao are proficient readers of online texts**  
Percentage of students at the different levels of digital reading proficiency, 2012



Source: OECD (2014), *PISA 2012 Results: What Students Know and Can Do* (Volume I, Revised edition, February 2014): Student Performance in Mathematics, Reading and Science, PISA, OECD Publishing, Paris.

**Figure 15. There is room to improve the task-oriented browsing behaviour of Chinese students**

Index of task-oriented browsing behaviour, from 0 (worst performance) to 100 (best performance), 2012



Note: A higher value on the index of task-oriented browsing reflects better browsing behaviour, with long navigation sequences that contain a high number of task-relevant steps and few or no missteps or task-irrelevant steps.

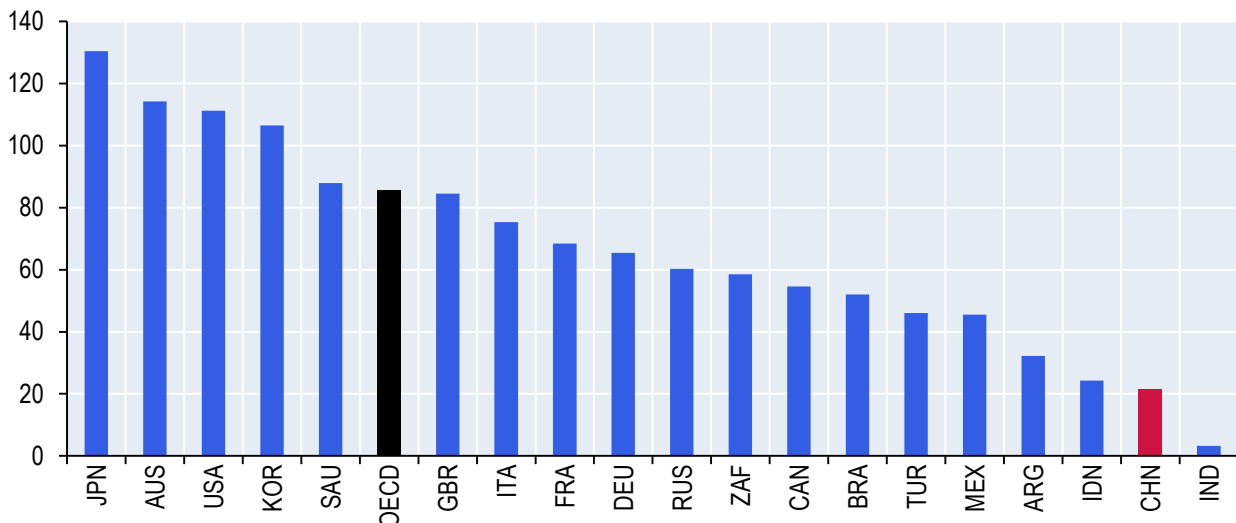
Source: OECD (2014), *PISA 2012 Results: What Students Know and Can Do* (Volume I, Revised edition, February 2014): Student Performance in Mathematics, Reading and Science, PISA, OECD Publishing, Paris.



## CHINA'S TRANSITION NEEDS TO BE UNDERPINNED BY 21ST CENTURY INFRASTRUCTURE

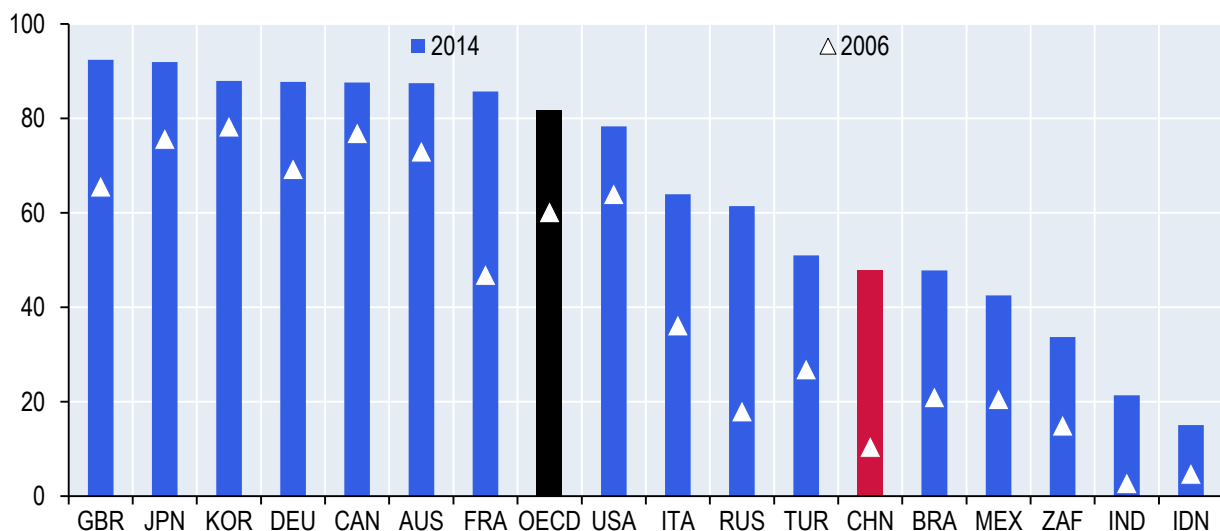
Efficient and reliable communication networks and services are the foundation on which the digital economy is based. Individuals and businesses, including SMEs, need reliable and widespread access to digital networks and services to benefit from digital opportunities and boost growth and well-being. However, China currently has one of the lowest penetrations of fixed and mobile broadband in the G20 (Figure 16), as well as a relatively low share of 16-74 year-olds that use the Internet (Figure 17). To realise the full potential of the digital economy, it is essential to promote investment and competition in the provision of high-speed networks and services, ensuring that key enablers are in place (e.g. sufficient spectrum and increasing uptake of IPv6 Internet addresses), as well as to encourage investments in data. Work on emerging economies in Latin America shows that this requires both demand-side and supply-side efforts, ranging from creating digital content accessible to local populations and promoting digital entrepreneurship to deploying infrastructures for regional connectivity. China may wish to engage in a forthcoming similar OECD study of broadband policy in Southeast Asia, which will explore good practices for maximising the potential of broadband for economic and social development.

**Figure 16. Mobile broadband penetration is low in China**  
Subscribers per 100 inhabitants, 2015 or latest available



Source: OECD and ITU World Telecommunication/ICT Indicators 2015.

**Figure 17. The share of adults using the Internet on mobile devices is lower than in many other countries**  
Total mobile Internet users, % of 16-74 year-olds, 2014



Source: OECD (2015), Science, Technology, and Industry Scoreboard, OECD Publishing, Paris.

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