



**PUBLIC GOVERNANCE AND TERRITORIAL DEVELOPMENT  
PUBLIC MANAGEMENT COMMITTEE**

**OECD-Asian Senior Budget Officials**

**PUBLIC SECTOR BUDGET MANAGEMENT ISSUES IN CHINA**

**Bangkok, Thailand  
15-16 December 2005**

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## EXECUTIVE SUMMARY

1. China has undertaken extensive reforms to its budgeting system over the past ten years. These have encompassed the entire budgeting cycle: formulation, approval, implementation and audit. The paper reviews each of these elements.
2. China has made crucial progress in this field. The early challenge was fundamentally to create the institutional infrastructure for a modern budget process where none had previously existed. In the planned economy, all resource allocation decisions were made in the plan with the budget serving essentially as a secondary accounting device.
3. China now has the basic budgeting infrastructure to build on. The paper, however, argues that the budgeting system remains marred by key weaknesses that remain to be overcome.
4. The budget is still not complete in that important decisions are made outside of the budget process. The capital budget is made separately from the recurrent budget with key decisions made by the National Development Reform Commission (NDRC, the former State Planning Commission). Despite improvements over the years, off-budget expenditures continue to be large and unreported. The Ministry of Finance (MOF) still does not have comprehensive authority on spending. Staffing decisions, which have major spending implications, are made by the State Commission Office for Public Sector Reform with little consultation with fiscal authorities.
5. The greatest challenge, however, for China is its highly decentralized fiscal system. China consists of five levels of government – national, provincial, prefectural, counties and townships. The national government only accounts for about 30% of total government expenditure in China. The remaining 70% of expenditures is accounted for by the four sub-national levels of government with the third and fourth tiers accounting for the greatest share. For example, prefectures and counties account for nearly all expenditures for social security including old-age pensions, unemployment insurance, and other income support and welfare schemes. Moreover, the central government lacks effective control over the fiscal relations between provincial and lower-level governments which is manifested by distinct differences across provinces.
6. With sub-national governments playing such a vital role, improvements in budgeting in China depend critically on associated changes being implemented at these levels. The achievements in budgeting have largely been at the national level and in the wealthier coastal provinces.
7. China is almost unique in having virtually no system of intergovernmental transfers that are designed to ensure adequate financing at the local levels for meeting national mandates in the provision of critical public services such as basic education, pensions and unemployment benefits.

## PUBLIC SECTOR BUDGET MANAGEMENT ISSUES IN CHINA

### Introduction

8. In November 2003, the Sixteenth National Congress of the Communist Party of China celebrated China's remarkable economic achievements over some 25 years of transition to a market economy, but also called for some significant corrections. One clearly identified strand of correction aims to renew the Party's commitment to a more balanced growth that benefits all regions and sectors and stem the alarming growth in inequalities that has marred the achievements of the recent years. This was spelled out in more specific terms in Premier Wen Jiabao's Report to the National People's Congress (NPC) on 5 March 2004, when he called for:<sup>1</sup>

- Reorienting China's development strategy to one that emphasizes balanced, sustainable and "people-centered" growth;
- Strengthening social protection;
- Solving fiscal problems of the rural sector;
- Curbing corruption and government abuse;
- Putting China on a timetable to achieve a "*xiaokang* society" (a well-off society). Although the indicators for "*xiaokang*" are still being worked out, they will include socio-economic indices such as educational attainment, access to clean water and health care, etc. that mimic closely those used by international organisations to measure "human development".

9. What is notable about this call for a *xiaokang* society is that, for the first time, the government is explicitly focusing on targeting the *outcomes* of economic growth, shifting away from the traditional emphasis on the quantitative targets such as *rates* of growth and income levels. This new emphasis on outcomes will bring more scrutiny onto government performance, since the public sector is the primary provider of many of the services that are critical to achieving a "people-centered" growth. To achieve the goals set out will require improving public expenditure management and ensuring that government spending is more tightly linked to priorities, improving budget processes and execution, and holding government accountable for improving its performance. Indeed, in a speech during 2002, then-Vice Premier Li Lanqing called improving public expenditure management "an important guarantor for the achievement of *xiaokang* society"(Xiang and Lou, 2004). In sum, the pressure is on to improve public expenditure management.

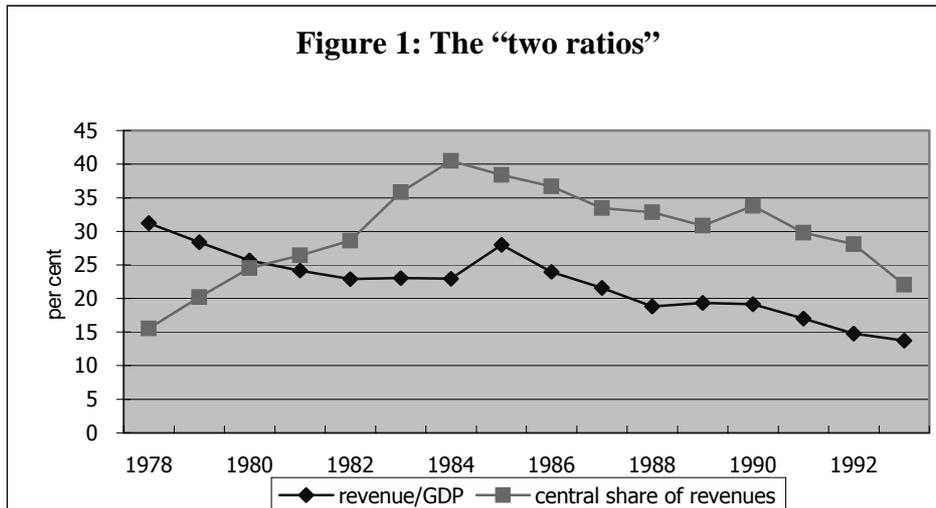
10. This chapter discusses the main issues in public expenditure management in China. It provides an update on earlier OECD publications on the budget management system (OECD, 2002), focusing on the reform measures being implemented and their objectives, what improvements have been achieved, what obstacles these reforms face and why. Section I briefly explains the background to budget reform. Section II discusses the package of reforms being implemented. Section III reports on achievements to date and the problems in going forward. Section IV provides a brief summary and conclusion.

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<sup>1</sup> Traditionally, the premier appears at the annual NPC meetings in March to present a report on the work of the government. This report reviews the achievements of the past year and outlines the main undertakings for the coming year. It provides the occasion for presenting major new policies and changes in direction.

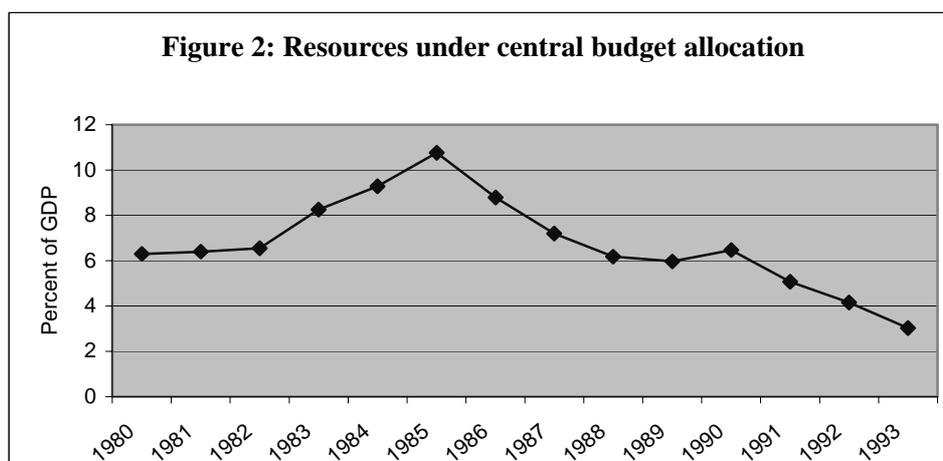
## I. The background to budget management reform

11. As noted in previous publications, reform of the budget management system has lagged behind other reforms in China.<sup>2</sup> This is an unsurprising feature of an incremental, gradual approach to reform that has, at least through the first decade, relied primarily on liberalization. While the gradual reduction of government control has worked wonders in the productive sectors by releasing pent-up energies and resources and improving allocative efficiency, the approach has worked less well in effecting change in the core economic institutions. By the early 1990s, the budget was weak – with the revenue mechanisms of the planned economy undermined by market forces, revenues had fallen to a low of 11% of gross domestic product (GDP). As part of its effort to mobilize revenue collection, the central government had turned over an increasing share of revenues to local governments. The result was that by 1993, the central share of revenues had fallen to just 22% of the total (see Figures 7.1 and 7.2). With central government finances in peril, it was not surprising that fiscal reform became an urgent agenda item in the early 1990s, or that the first efforts were focused on “raising the two ratios”, *i.e.* to increase the share of revenues in GDP and the central share of total revenues. It was only in the late 1990s, with the upturn in revenue collection assured and with the central government regaining control over more than half of the revenues, that attention turned to improving the efficiency of public expenditures.



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<sup>2</sup> See OECD (2002), World Bank (2000) and World Bank (2002).



12. At the outset of budget reform, the weaknesses of China’s budget system were explained by one senior official of the Ministry of Finance (MOF) as follows:

*“The budget submitted for examination and approval at the beginning of the year was a rough budget that was drafted by function only and did not show the budget allocations to departments. It did not reflect specific details of revenues or expenditures. There was no overall expenditure limit. It did not reflect all revenue and expenditure activities. The government’s fiscal policy had only coarse control over the expenditure composition; our capacity to control and manage public expenditures was very weak.” (Chen, 2003)*

13. Chen (2003) described the budgeting process as “chaotic”, characterized by fragmented control under numerous bodies and departments, and lacking transparency and accountability over the management of resources. Within the MOF, numerous departments or bureaus were involved in budgeting, with each one in charge of one or more expenditure items, which were divided and allocated to many ministries or departments. For example, the department in charge of “capital construction expenditures” had to interact with all ministries and departments, thus limiting the amount of detailed budgeting that was possible. In turn, the spending units had to make budget proposals to many departments in the MOF. To add to the confusion, allocative authorities for capital expenditures rested mostly outside the MOF, in the (then) State Planning Commission and the Ministry of Science and Technology, to which spending units also had to apply. This budgeting process made it difficult to exert expenditure control over any ministry whose budget came from a number of ministries, commissions, departments and bureaus, and there were no set limits. For grassroots spending units the situation was murkier still: because reserves were set aside for contingencies at every level and doled out throughout the budget cycle as line ministries allocated their budgetary funds downward by line item and by project, bargaining for budget appropriations continued throughout the fiscal year. Moreover, the budget was not comprehensive, and many resources were outside the budget, in extra budgetary accounts, a topic treated below in section III. It was also commonly accepted that new spending needs that could not be accommodated within the budget could provide justification for the introduction of new fees, a practice that further softened the budget constraint on spending units (see Box 7.1 for an illustrative example). As Chen (2003) noted, “[t]he drafting of the budget was very arduous and involved ongoing conflicts.”

### **Box 1: An in-year budget request**

In 1997, two months after the budget passed, a line ministry approached the MOF for additional funding for a certain high priority function. To increase its capability in this function, the ministry asked for (in order of preference): *i*) a tax earmarked for this function; *ii*) a special fund for this function; *iii*) a rule to increase expenditures on this function by more than revenues; *iv*) to earmark the fines the ministry collects for this function; and *v*) a grants system to counties for the specific function.

In an OECD country, the MOF answer to the request could be as follows. First, the budget has just been passed, so the ministry would have to wait for next year's budget round. Second, if the function falls within the government's priorities, financing should first be sought within savings from the ministry's other, non-priority activities. If budgetary money were still needed, the proposal would have to specify the concrete activities planned for achieving the government's strategic goals. Furthermore, the line ministry should specify measurable indicators for success of the policy, and – in some OECD countries – would be required to present an evaluation plan.

Even if the final proposal were satisfactory and accepted during the regular budget round, it would rarely happen in an OECD country that the line ministry would obtain earmarked revenues for the function. Rather, it would be funded from general revenues.

*Source: World Bank (2000), Box 4.1.*

## **II. The reform package**

14. Given this backdrop, it is easy to understand the MOF view that improving public expenditure management required first regaining control over the budget process. Since 1999, a broad package of reforms in budget management has been introduced, covering reforms in budget preparation, budget classification, treasury management, government procurement and installing new information systems.

### ***Reforms in budget preparation – introduction of departmental budgets***

15. The centrepiece of the reform in budget preparation was the introduction of departmental budgets, which had several important objectives:

- *To improve transparency.* In the past, the budget showed appropriations by sector, and the sectoral amounts were cut up into pieces for different ministries and organizations. Therefore, it was hard to know how much education and training, for example, was performed by each ministry.
- *To improve budgeting.* Under the system prior to the introduction of departmental budgets, making budget proposals to multiple departments and organisations was a cumbersome and unpredictable process for spending units.
- *To harden the budget constraint for each spending unit.* The absence of a departmental breakdown in the budget approved by the NPC meant that there were no firm spending limits per line ministry. Instead, the sectoral budget was a common pool of funds for individual line ministries operating in the sector, and it opened the door for the ministries to lobby the MOF for more funding throughout the year for priority projects. With a departmental budget, approval by the NPC ends the negotiation for resources.
- *To improve accountability for spending.* With departmental budgets spelling out how much is being spent by each spending unit, the precondition now exists to hold each ministry responsible for delivering results.

16. In the 2000 budget cycle, four central ministries were chosen for piloting: the Ministry of Agriculture, the Ministry of Education, the Ministry of Science and Technology, and the Ministry of Labour and Social Security. On the basis of their experiences the MOF designed new budget proposal forms and software and began training and dissemination to the other line ministries. In the following year, 29 departmental budgets were presented. This system has been quickly adopted in some localities. In Hebei Province, one of the pioneers in budget reform, departmental budgets were already being prepared in 2000 for the first level budgetary units at the provincial level. At the next level of prefectures and municipalities, Wuhan reported that it began in 2000 by presenting departmental budgets for five units under four departments. By the following year, they were presented for all 115 municipal departments (Yang, 2002).

17. The introduction of departmental budgets has facilitated and sometimes necessitated other reforms, which include the following:

18. **Detailed budgeting.** Also in line with the objective of regaining control over the budgeting process is the trend toward specifying more line items in budgets, under the call to “change the practice of presenting budgets on a single piece of paper to presenting budgets as books”. In the circular issued in 1999, Concerning Improvements in the Central Budgeting for the 2000 Budget, the MOF laid the groundwork for the detailed preparation of departmental budgets by requiring that all planned expenditures be listed in the budget proposals, with the proviso that those not listed would not be funded. Some localities have followed suit to such an extent that in January 2003, delegates to the Guangdong Province People’s Congress were surprised and delighted to be presented with a 600-page provincial budget for discussion.<sup>3</sup> Following the trend to present detailed budgets, the municipality of Wuhan has similarly transformed its budget presentation from “two pages to two books”(Yang, 2002).

19. **Comprehensive budgets.** The circular on the 2000 budget also required each line ministry to include all extra-budgetary revenues and expenditures in their budget proposals. Since most fees and charges collected by line ministries had been approved under the rationale that they were needed to help finance identified new services, the MOF used the opportunity of formulating departmental budgets to require reporting on these extra-budgetary resources in order to present an integrated budget that reflects all resources and expenditures of the department.

20. This has proved to be a major side benefit of the introduction of departmental budgets. The information gathered has facilitated the process of reviewing, rationalizing and gradually reining in extra-budgetary revenues – a process that had begun a few years earlier. Under the slogan “separating revenues and expenditures into two channels”, the MOF has begun to budget for expenditure needs separately from the department’s own revenue situation. This is due to the fact that the information on extra-budgetary revenues has finally provided the precondition for enforcing the fiscal rule first announced in 1996 (State Council Document No. 29) that extra-budgetary resources are fiscal revenues subject to allocation by government, rather than the collecting body. If fully implemented, asserting this fiscal rule could bring extra-budgetary revenues under budget allocation, a major step toward improving the comprehensiveness of the Chinese budget.<sup>4</sup>

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<sup>3</sup> *Southern Weekend*, 23 January 2003. Even so, the review was, in the words of one delegate, “largely symbolic”. Many delegates complained that it was impossible to conduct a thorough review since they received the budget only a few days prior to the meeting. They called for the establishment of a budget oversight committee within the legislature to review the budget in advance and in greater detail, before submitting it to the delegates (*China Law and Governance Review*, January 2004, No. 1).

<sup>4</sup> In remarks at an OECD meeting in December 1998, Vice Minister Lou Jiwei spoke of government fees and charges equal to about 10% of GDP and “not entirely under the control of the budget”. Since then, the size of

21. **Renewed focus on “norms”.** Paradoxically, in order to implement comprehensive budgets and to end the inequitable situation where departments that could levy fees and user charges had plentiful running costs while those with poor access to extra-budgetary revenues were starved for funds, the government has also focused on collecting cost information for line item expenditures and setting “norms” for budgeting. A pilot reform was introduced in ten central ministries and departments in 2003 with staffing “norms” and expenditure norms, including in the National Development and Reform Commission (NDRC), the Science and Technology Commission, and the then-State Economic and Trade Commission.

22. **Prioritization of expenditures through zero-based budgeting.** To move away from the passive, incremental budgeting based on past allocations, the MOF has also promoted the use of zero-based budgeting to review all expenditures including staffing levels.

23. **Budget classification reform.** To improve the informational content of budget presentations to facilitate analysis, the reform package has also included a reform of the classification system. Under the Soviet-type system adopted in the 1950s, budget categories were broad, and were a mix of organisational and functional divisions that did not allow government to disaggregate expenditures by sector or economic function – for example, it was impossible to know the personnel share of expenditures in any sector or department. To improve transparency and aid analysis, China is adopting a Government Finance Statistics (GFS) system with some modifications. Some changes have been introduced since 2002 and are used in budget preparation at both the central and sub-national levels. Even at the lowest tiers of government, the new GFS-based classification system that is in use shows expenditures by organisation and by economic function. A full rollout of a new classification system is scheduled for mid-2005.

24. **Internal reorganisation of the MOF.** In accordance with the new budget preparation procedures, in June 2000 the MOF undertook a major reorganisation of its internal structure to end the “chaotic” process described earlier, to strengthen its interface with spending units. Although several departments are still involved in budgeting – *e.g.* the culture and education department, the agriculture department, the industry and transport department, etc., each department now has comprehensive responsibility for overseeing preparation of the whole budget of spending units within their jurisdiction. This has allowed spending units to make budget proposals to only one “window”.

### ***Reforms in budget implementation***

25. **Treasury reform.** At the heart of efforts to improve the government’s ability to control and monitor budget implementation is treasury management reform. Prior to the current reforms, China had a highly decentralized system of treasury management that did not provide the information needed by the MOF to monitor and enforce budget implementation. Some functions – such as cash management – were not performed at all, whereas control over bank accounts was not effectively enforced. The system had the following features:

- The legal basis for the treasury function was weak. The budget law did not put the MOF squarely in charge of government money, nor did it clearly define what government money is.
- Line ministries and spending bodies had their own bank accounts and were responsible for their own payments.

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these extra-budgetary revenues has declined as some fees and charges were reclassified as budgetary revenue or as business incomes of the government bodies and excluded from extra-budgetary accounts.

- Expenditure reporting from spending units to the MOF was *ex post*, and on a highly aggregated basis.
- No reconciliation of spending reports and bank account statements took place until after the end of the budget year.
- MOF controlled only the disbursement of funds from the general treasury account (in the People's Bank of China) to the line ministry account. While it was informed on the balance in this account on a daily basis, it had no information on the overall cash position of the government, nor could it use idle balances in the accounts of line ministries and spending units.
- Line ministries and bodies had multiple extra-budgetary accounts which largely fell outside the oversight of the MOF, on which reporting requirements were lax.
- The central bank's management system did not allow direct deposit from the central treasury account to regional accounts, nor did it allow direct deposit from one level of government to another without going through a time-consuming, elaborate process of interbank clearing.
- Transfers of tax revenues from taxpayer to the central treasury were subjected to a similarly slow interbank clearing.

26. The treasury system resulted in a number of weaknesses:

- Government had higher interest costs as large amounts of cash sat idle in spending units' bank accounts, while the central treasury was issuing debt to raise funds.
- Government lacked information on the stance of fiscal policy, because no information on actual spending was available on a timely basis.
- Government could not adjust aggregate spending at short notice, because line ministries could continue to spend from their budgetary and extra-budgetary bank accounts.
- Government could not stop abuse of funds until after the fact, because the system did not allow for *ex ante* spending control.

27. The inefficiencies and lack of accountability inherent in this system are illustrated by the following example from the Ministry of Water Resources: budgetary appropriations for capital spending go through as many as seven layers before reaching the project entity. Because of delays *en route*, in 1999, there were undisbursed funds of RMB 4.6 billion at year end. During the first ten months of 2000, in the aggregate there was an average balance of RMB 5.6 billion in the various bank accounts within the system (Xiang and Lou, 2004).

28. In July 2001, China began to implement treasury management reform on a pilot basis. The new treasury system would recognize five types of accounts:

1. A treasury single account at the central bank that manages all fiscal resources and is controlled by the MOF.
2. Special accounts at commercial banks set up either by the MOF or by spending units on authorization from the MOF, for small expenditures.
3. Extra-budgetary accounts controlled by the MOF and deposited at commercial banks.
4. Petty-cash accounts set up by the MOF on behalf of spending units at commercial banks to take care of miscellaneous transactions.
5. Special accounts set up by the MOF for earmarked, transitory activities under State Council or provincial government approval.

29. Under the new system, all fiscal revenues would enter directly into either the treasury account or one of the other special accounts, all of which are controlled by the MOF. No other bank accounts would be allowed for spending units.

30. The reform started cautiously. In 2001, a Treasury Disbursement Centre (TDC) was created at the central level to manage the budget general ledger and approve disbursement claims. Six central ministries and departments were chosen to pilot the new treasury system, including the MOF, the Ministry of Water Resources, the Ministry of Science and Technology, and the State Council Law Office. Together they accounted for RMB 17 billion in budgetary expenditures, equal to about 3% of central government budgetary expenditures net of transfers. A 38% share of their expenditures was directly disbursed through the TDC, and 62% was disbursed by spending units under delegation by the MOF. In addition to the pilot ministries, the TDC made direct disbursements on some earmarked funds including vehicle purchases from the Special Fund for Transport, grain storage facilities construction fund, and government procurements.

31. Some localities introduced treasury management pilot experiments at the same time. The province of Hainan has adopted direct disbursement on all government procurement. Tianjin has cancelled transit accounts and required all fiscal funds to be directly deposited in the treasury of fiscal special accounts. All government procurement and capital construction funds are directly disbursed by the municipal TSA (Zhang, 2002). By far the most extensive reach of the new treasury system has been in the direct disbursement of civil service salaries, which has been introduced in many localities. Associated with the direct payroll disbursement has come much improved information flows: the MOF now boasts of having more than 20 items of personal information on every civil servant in the country, and it has access to information on the government's fiscal stance on a daily basis. By 2004, TDCs and disbursement offices have been set up in most localities all the way down to the county level.

32. **Government procurement reform.** The reform programme has also sought to improve cost efficiencies and to reduce the scope for corruption in government procurement by adopting many of the procedures of international organisations for tendering large-scale purchases of vehicles and equipment, as well as service contracts. A State Procurement Law was passed in 2002, with full implementation beginning in January 2003.

33. **Government financial management information system reform.** To meet the needs of treasury reform and improved budgeting, the MOF began work on a new government financial management information system in 2000 under the "Golden Finance Project" (see Chapter 4). The aim is to provide a system that permits information sharing and supports the operations of MOF departments concerned with budget formulation and monitoring, disbursement, cash management, payroll disbursement, debt management, government procurement, state asset management, revenue management and economic forecasting. The Golden Finance Project has also created a platform that unified data reporting standards throughout the fiscal system, with software provided to sub-national governments all the way down to the township level. As a result, the MOF is now able to obtain more timely information to support analytical capacity.

### III. A glass half full? The current status of public expenditure management

34. If credit for the initiation of budget reform had to be attributed to a single event, it would be the China National Audit Office's (CNAO)<sup>5</sup> audit report of the central budget in 1999, which issued stinging criticisms of the 1998 budget implementation:

- Authorizations for spending ministries were not made until 1-5 months into the fiscal year; some ministries did not receive their budgets until the fourth quarter.
- Management of government funds was lax – in some instances funds were diverted to illegal uses, such as investing in companies and buildings; some were even sent to overseas accounts.
- Reporting requirements for extra-budgetary funds (EBF) were routinely ignored – even the MOF failed to present final accounts for the EBF that are included in the budget.
- Losses, failure to collect and diversion of extra-budgetary fees were rampant. Illegal uses included pension reserves that were invested in companies or used for speculation in the securities markets.

35. These criticisms prodded the NPC to demand some immediate changes in budgeting procedures. Among them:

- Spending ministries be given timely authorizations;
- Organisational budgets be introduced, to increase accountability for public funds;
- Standardized procurement procedures be implemented to cut waste and corruption;
- Public disclosure of all intergovernmental transfers by province;
- Greater consultation with the NPC, including more detailed presentation of the budget.

36. As described in section II, reforms implemented over the past 4-5 years have mainly been in response to these demands. The major effort has gone into the introduction of organisational/departmental budgets. At the July 2003 Central Government Work Conference on Departmental Budgets, Vice Minister of Finance Lou Jiwei noted that achievements from the introduction of departmental budgets included the following:

1. one budget for one department;
2. zero-based budgeting;
3. integrated budgets; and
4. establishment of internal budgeting rules for the MOF and central departments.

37. For 2004 and beyond, he stated that continuing reform will aim to move toward building a multi-year framework and an efficient performance evaluation system for spending programmes. In the meantime, he promised to continue improvements on norm-setting, budgeting procedures and building flexibility into departmental budgets (Lou, 2003).

38. With the reforms to date, China appears to be, step-by-step, putting in place the infrastructure necessary for building a modern system of budget management. Although some measures, *e.g.* detailed budgeting and norm-setting, appear to run counter to the trend in OECD reforms in budgeting, they can be understood as part of the process of regaining control over the basics. The 2003 report of the CNAO noted approvingly that since the 1998 audit, the government has drafted more than 400 measures to improve financial management. While “[t]he 1998 audit [had] identified violations amounting to 16.4 billion RMB,

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<sup>5</sup> Formerly called State Audit Administration.

by 2001 the amount of such violations had fallen ... to 2 billion RMB, with a pronounced reduction in major violations at the central-department level” (Li, 2003).

39. However, in spite of the many advances, the budget management system remains marred by some of the weakness noted in earlier studies.

***The budget is still not comprehensive***

40. First, the capital budget is made separately from recurrent budgets, and capital spending decisions are not required to co-ordinate with fiscal authorities even when these decisions create large recurrent costs downstream.<sup>6</sup> To some extent this reflects the continuing rivalry between the NDRC (then called the State Planning Commission) and the MOF, which is hindering co-ordination. Under the planned economy, resource allocation was made primarily by the plan – controlled by the State Planning Commission, with the budget playing only a supporting role in financing the plan. With the NDRC retaining control over the capital budget, it is still forcing the MOF to play an accommodative role.

41. **Extra-budgetary expenditures remain large** (see Box 2). While the introduction of departmental budgets has succeeded in incorporating fees and levies into budgetary accounts (item 1 in Box 7.2), and improved budgeting and SOE reform have likely reduced the size of items 2 and 3 in recent years, they have certainly not eliminated them. Activities in items 4 and 5 remain large and unaccounted, and appear to have grown in the past few years.<sup>7</sup>

**Box 2: China’s large extra-budgetary revenues and expenditures**

In the 1990s China became increasingly dependent on using extra-budgetary resources to finance government, especially at the sub-national levels. For many local governments, these financed half or more of all expenditures of government, and they comprised:

1. Fees and levies collected by branches of government and spent off budget.
2. Expenditures of branches of government that are not reported in budgetary or extra-budgetary accounts
  - a) Tax expenditures – tax incentives or tax credits
  - b) Payments arrears – unpaid/deferred wages to teachers and civil servants, unpaid subsidies to the grain marketing system, unpaid interest subsidies to the banking system on policy loans, unpaid utility and telephone bills of government bodies, etc.
  - c) Goods and services provided to government at less than full compensation.
3. Quasi-fiscal expenditures of state-owned enterprises and public service units – for the provision of schools, health care and housing, etc., as well as carrying surplus workers on payrolls (in lieu of unemployment payments by the government).
4. Quasi-fiscal expenditures of government – directed credit to state-owned enterprises (SOEs), uncollateralized loans to public service units and local governments through the banking system.

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<sup>6</sup> Blondal (2002) cited the example of the decision to build the National Library, which was made without consultation with the MOF even though once built, the MOF was obliged to provide a substantial recurrent budget for the library’s operation.

<sup>7</sup> Some evidence for this was provided in the State Audit General’s reports to the NPC in 2003 and 2004.

5. Commercial incomes or losses of government branches, and revenues from asset sales. In recent years, the sale of land leases and the use of land by local governments in development schemes have grown rapidly and are becoming a source of concern in the banking sector.

42. Off budget government spending remains large and unreported. Despite progress on curbing extra-budgetary levies, governments and bodies continue to raise large amounts of “self raised funds” – nearly all infrastructural investments are financed off-budget, in non-transparent ways and poorly tracked. The involvement of government and other public bodies in land and real estate developments has loomed as a major cause of overheating in the Chinese economy.

43. Policy makers continue to use tax expenditures whose costs are not reported in the budget. Most recent examples include: tax exemptions for industries and regions hard-hit by the epidemic of Severe Atypical Respiratory Syndrome in 2003 and tax preferences for the Northeast provinces to aid in “resuscitating” the rustbelt.

44. **The MOF still does not have comprehensive oversight authority on spending.** Staffing decisions, which have major spending implications, are made by the State Commission Office for Public Sector Reform and its local branches, with little consultation with fiscal authorities. Top political leaders still intervene too often to make policy unrestrained by budgetary vetting. For example, the decision taken by then-Premier Zhu Rongji to significantly increase civil service salaries greatly increased government financing requirements, but the MOF had little influence over the decision.

45. **Co-ordination between central and local governments is improving, but remains weak.** Policies made by central government usually have financing implications for local governments, but local governments are not always consulted before rollout. For example, most local officials reportedly learned of the salary increase for civil servants from TV broadcasts even though the costs were mostly borne at the local level. But improvements are clearly evident in consultation with local governments in recent years – for example, the recent reforms in rural fees and agricultural taxes have been worked out with local governments, but compensation remains only partial.

46. Many earmarked transfers arrive late in the year and in unpredictable amounts. The matching funds requirement means that local governments have to hold significant reserves of funds in the event that they are successful in getting projects allocated (World Bank, 2002).

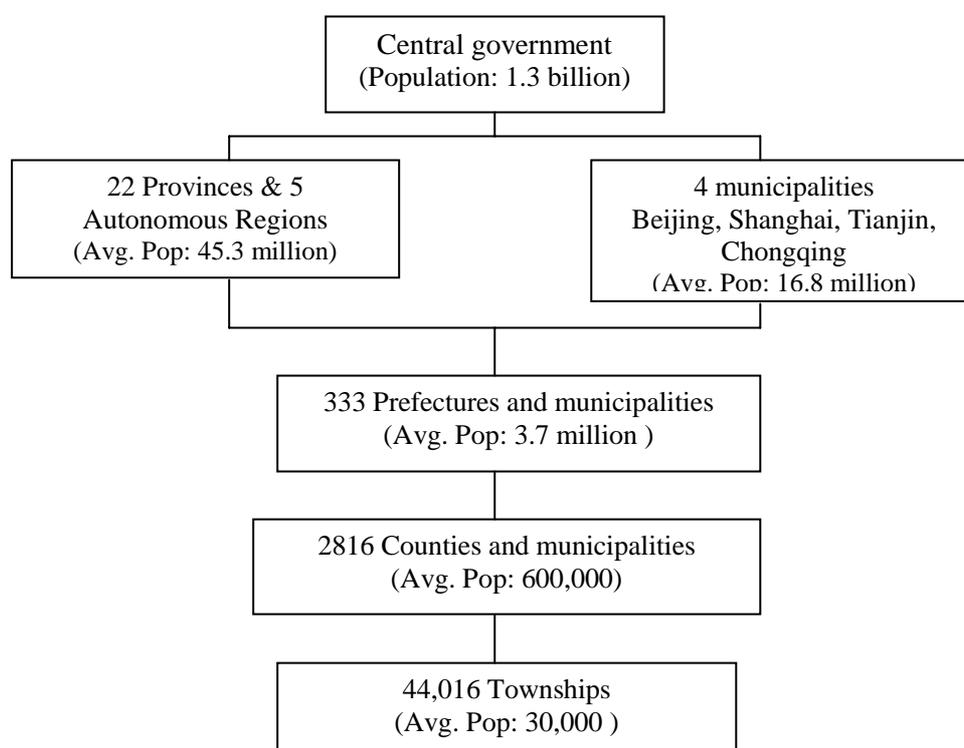
47. **Revenue forecasting remains weak** and pegged to directive growth targets, rather than economic fundamentals, and reporting on contingent liabilities is weak to non-existent.

***Extension of improved budgeting to the sub-national levels is limited***

48. Public expenditure management in China is complicated by the country’s huge size and diversity, since policies formulated in Beijing have to filter through several layers of bureaucracy before reaching the public. How the signals are transmitted through these complex organisations, and what incentives lower-level agents have to respond to these signals jointly determine the outcomes.

49. Several aspects of China’s structure of government have important implications for its system of public expenditure management. There are five tiers of government and five levels of budgeting (see Figure 7.3). The Budget Law requires every level of government to make its own budget and have it approved by the People’s Congress at that level.

**Figure 3 Structure of government in China (2003)**



*Note:* The figures exclude Hong Kong, Macao and Chinese Taipei.

50. Compared to other countries, the organisational structure of the Chinese fiscal system is exceptional in two important respects. First, it is highly decentralized: the central government accounts for only 30% of total budgetary expenditures (see Table A1 in the Annex). The rest is distributed among the four sub-national tiers, with 55% spent at sub-provincial levels. By comparison, sub-national governments account on average for only 14% of total budgetary expenditures in developing countries, and 32% in developed countries.<sup>8</sup>

51. This decentralization is even more notable because China is virtually unique among countries in the world in assigning responsibilities for providing vital social services such as social security, basic education, health care and public safety to local governments. Cities at the third and fourth tiers account for all expenditures for social security: pensions, unemployment insurance, and other income support and welfare schemes. Counties and townships (fourth and fifth tiers) are together responsible for providing basic education and public health for the rural populace – these two tiers account for 70% of budgetary expenditures on education, and 55-60% of expenditures on health. Table A2 shows that these expenditure assignments in China deviate significantly from those in other countries and helps to explain the high share of expenditures at the subnational levels. With sub-national governments playing such a vital role, improvements in budgeting in China depend critically on associated changes being implemented at the grassroots levels.

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<sup>8</sup> The sample comprises about 100 countries for which sub-national budgetary data is available from IMF, World Bank, OECD and other sources. Bahl (2002).

52. The second exceptional feature of China's fiscal system is that decentralization occurred in an incremental and unco-ordinated fashion, a process that left revenue and expenditure assignments significantly mismatched, with local governments largely self-financed, and provision of services to the local populace vulnerable to variations in local fiscal health. The problems of this intergovernmental fiscal system were examined in detail in the 2002 World Bank report, *China: National Development and Subnational Finance*, which came to the firm conclusion that the current intergovernmental arrangements were dysfunctional, and the shortage of revenues at the lower tiers and especially in poor regions constituted a bottleneck to national policy implementation.

53. Through the 1990s, revenue inadequacy was also a major cause of poor budgeting practices at the sub-national levels, which replicated most of the weaknesses at the central level. In fact, the rise of extra-budgetary revenues in the 1990s was in large part attributable to budgetary shortfalls and the exhortation by higher level governments for local governments to go out and "find local solutions" to fiscal gaps. Over the years, extra-budgetary revenues have been funding many needed services (World Bank 2002, Wong 1997, 1998; Fan 1998). This is illustrated in Table 7.1, which shows the extent to which key public services in Hunan province (a middle-income province) are financed from extra-budgetary funding, including salary payments for public employees.

**Table 7.1: Sources of revenue for major expenditures in Hunan Province (1999)**

(billion RMB)	Budgetary Allocation	Actual Expenditure	% financed by budget	Personnel costs	
				Personnel Costs	As % of budget allocation
<b>Education</b>					
Primary Schools	1.44	3.33	43%	2.45	170%
Middle Schools	1.73	3.55	49%	2.45	142%
<b>Health</b>	1.17	7.23	16%	2.57	220%
<b>Agriculture</b>	2.27	3.16	72%	0.87	38%
<b>Urban Maintenance</b>	1.28	1.55	83%	0.5	39%

Source: World Bank (2002), Table 5.2.

54. In recent years, as the central government has stepped up transfers to alleviate funding problems at the sub-national level, the nature of the problem has shifted somewhat, to issues of improving the mechanisms of transfer to achieve efficient outcomes.

55. To improve budgetary practice and the efficiency of public expenditures at the sub-national level, and to rein in extra-budgetary revenues and activities, will require some fundamental reforms of the intergovernmental fiscal system – a long and protracted process that has only just begun.

***Compliance with existing laws and regulations needs strengthening***

56. While the thrust of reform efforts has been to strengthen the framework for expenditure management, recent audit reports point to significant problems of non-compliance with existing rules and regulations by government bodies, starting with the MOF. For example, the 2003 audit report complained that despite rule changes to discourage in-year incremental budgeting and stipulating tougher rules on supplemental budgets, both the MOF and the NDRC released significant funds in the course of the fiscal year (Li, 2003). According to both the 2003 and 2004 audit reports, the use of tax expenditures for policy purposes continued apace and unrecorded. In 2002, the MOF used value-added tax and income tax refunds totaling RMB 1.36 billion to support the Three Gorges Dam construction and resettlement. In 2003, central

ministries spent RMB 28.2 billion in tax rebates of various forms to compensate state-owned enterprises (mostly in nine enterprise groups) for their quasi-fiscal expenditures in providing education, health care, and social security. “These methods of handling the expenditures is not according to regulations [...] and should have been reported as budgetary expenditures instead” (Li, 2004). Both the 2003 and 2004 reports also point to many instances of diversion of earmarked subsidies to unintended uses, local borrowing against regulation, and falsification of revenue and expenditures.

#### IV. Next steps?

57. The current programme of budget reform comprises a large, complex and ambitious package of measures that are long overdue, and they will be crucial in moving China toward a modern budgeting system and a well-functioning public sector. However, these reforms are only just beginning, and they are focused at the central level.<sup>9</sup> Given the decentralized fiscal system, the reforms will have to be implemented at all levels of government, a process that promises to be protracted and difficult.

58. To date, the government has focused mainly on tackling technical issues:

- Revamping budgetary processes;
- Improving treasury management;
- Improving government procurement procedures;
- Introduction of new payroll systems to monitor and control payroll expenditures;
- Introduction of improved accounting and financial reporting on extra budgetary funds, elimination of many fees and incorporation of others into the budget;
- Introduction of new debt management procedures to improve information and tracking of government debt and contingent liabilities;
- Introduction of a new government financial management information system to improve information flows within the MOF and linking up with provincial databases.

59. Reforms have shied away from significantly tackling areas that involve political challenges, such as:

- Redefining the role of government and refocusing budget priorities
- Limiting policy initiatives outside the budgetary context to improve orderly prioritization, and especially
- Enhancing the role of civil society.

60. There has also been little public discussion of the need for a major realignment of the intergovernmental fiscal system in spite of the many changes underway since 2000 as a result of reforms in the rural sector.<sup>10</sup>

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<sup>9</sup> The examples of Wuhan Municipality and Hebei Province cited above notwithstanding, budget reform has been mostly a central government activity to date, with sub-national participation limited to a selected few. The rest of the country is little involved. This picture is strikingly similar to that for civil service reforms described in Chapter 1 of this study, with a modernizing core that comprises the central government and selected coastal areas, and a large unreformed “other” area.

<sup>10</sup> Since 2000, reforms have been gradually rolled out to eliminate all fees and levies in the rural sector. Beginning in 2004, the government has also implemented a programme to eliminate the agricultural tax over a period of five years. These reforms are eliminating the bulk of the revenue base for governments at the township level and have necessitated some revisions to expenditure assignments between the county and the township, as well as a

61. Judging from the recent audit reports of the CNAO, the many difficulties government faces in enforcement highlight its continuing inability to enforce fiscal discipline and hold spending units accountable for results. Strengthening accountability mechanisms and enforcing aggregate fiscal discipline constitute the critical challenges for reforms in the next phase, and these will require government to tackle some of the political challenges avoided thus far. Fortunately, the prospects look far brighter in 2005 than in the late 1990s when budget reform was first initiated.

62. The single most important advance has been the growing prominence of the CNAO, whose annual reports have kept up criticism of the MOF and other government bodies at the central and local levels. Beginning in 1999, the Auditor-General has appeared each year at the NPC Standing Committee Meetings in June to present the Administration's report on the audit of the previous year's budget. In recent years, this has become a popular annual event that attracts a great deal of media attention and follow-up investigations by the press. This has generated continuing pressure to improve public-sector management and provided support for budget reform through the NPC. More importantly, the new "scientific development" paradigm adopted under Hu Jintao and Wen Jiabao, which calls for a more balanced, inclusive and people-centered approach, should translate into support from the top leadership for continuing reforms in public expenditure management – the vital ingredient that was missing in 1998.

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• proliferation of transfers from higher levels of government to fill the fiscal gap. For public expenditure policies also see Chapter 8.

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## Annex A

**Table A1. China's expenditure decentralization in comparative perspective**

	Sub-National Expenditure (as a percentage of National Expenditure)
China 2002	70
Developing Countries 1990s	14
Transition Countries 1990s	26
OECD Countries 1990s	32
Other large countries 1990s*	
Germany	40
India	46
Japan	61
Pakistan	29
Russia	38
USA	46

Source: adapted from Mountfield and Wong (2005), and Bahl (2002).

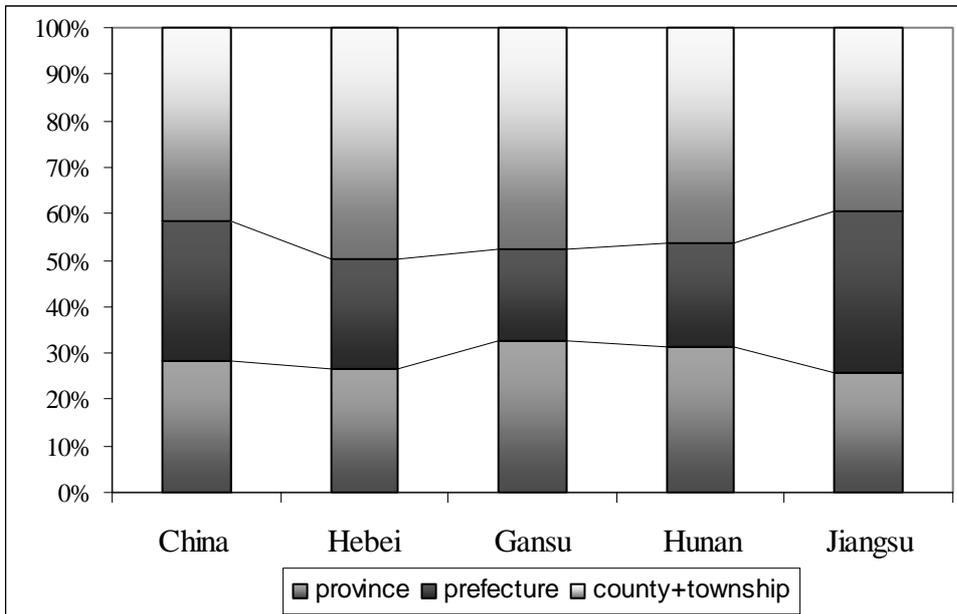
**Table A2. Expenditure Assignments**

	Defense	Foreign Affairs	Environment and natural resources	Unempl. and Insur.	Industry and agric.	Education	Health	Social welfare	Police	Highways
China	F	F	F,S,L	L	F,S,L	L	L	L	L	F,S,L
Vietnam (2004)	F	F	F, S, L	..	F, S, L	S, L	S, L	F, S, L	F	F, S, L
India (1)	F	F	F,S	F,S	F,S	F,S	S	F,S	S	F
India (2)	F	F	F,S	F,S	F,S	F,S,L	S,L	F,S	S	F
Japan (1)	F	F	..	..	L	F,L	F,L	F,L	L	..
Japan (2)	F	F	..	..	..	L	F,L	F,L	F,L	L
Malaysia (2)	F	F	L	..	F,S	F	F,S	F,S	F	F
(assignment of constitutional powers)										
Canada	F	F	F,S	F	C	S	S(F)	F,S	F,S	S
United States	F,S	F	F,S	F,S	S	S,F	S(F)		F,S	F,S
Switzerland	F	F	C	C	F,S	C,F,S	S,C	F,C	S	FS
Australia	F,S	F	F,S	C	S,C	F,S	F,S	C	S,F	F,S
Germany	F	F,S	C	C	C	C,S	C,F,S	C	C,S	C
Austria	F	F	F,S	F	F	F,S	C,F,S	C	F,S	F,S

Source: adapted from Mountfield and Wong (2005), Table 2.

Key: 1 = financing responsibility; 2 = provision; F = federal/national; S = state/province; L = local; C = concurrent (shared)

**Figure A2. Shares of sub-national expenditures (1999)**



Source: MOF and provincial officials.