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China
Managing Public Expenditures for Better Results
Country Economic Memorandum

April 25, 2000

Poverty Reduction and Economic Management Unit
East Asia and Pacific Region

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CURRENCY EQUIVALENTS

(As of March 31, 2000)

Currency	=	Renminbi
Currency Unit	=	Yuan (Y)
$1.00	=	Y8.2
Y1.00	=	$0.12

FISCAL YEAR

January 1 - December 31

WEIGHTS AND MEASURES

Metric System

ABBREVIATIONS AND ACRONYMS

ANAO	-	**Australian National Audit Office**
DEET	-	**Department of Employment, Education and Training**
DoF	-	**Department of Finance**
EBA	-	**Extra Budgetary Account**
EBF	-	**Extra-Budgetary Fund**
ECD	-	**Evaluation Capacity Development**
FM	-	**Financial Management**
FMIS	-	**Financial Management Information System**
GAO	-	**General Accounting Office**
MOF	-	**Ministry of Finance**
MOFTEC	-	**Ministry of Foreign Trade and Economic Cooperation**
MTEF	-	**Medium-Term Expenditure Framework**
MYEF	-	**Multi-Year Expenditure Framework**
NAO	-	**National Audit Office**
NCB	-	**National Competitive Bidding**
NGO	-	**Non-Governmental Organization**
NPC	-	**National People's Congress**
NPO	-	**Non-Profit Organization**
NPR	-	**National Performance Review**
NTD	-	**National Treasury Department**
OECD	-	**Organization of Economic Cooperation and Development**
PBC	-	**Peoples' Bank of China**
PEP	-	**Portfolio Evaluation Plan**
SAT	-	**State Administration of Taxation**
SOE	-	**State-Owned Enterprises**
SPC	-	**State Planning Commission**
SETC	-	**State Economic and Trade Commission**
SRF	-	**Self-Raised Fund**
TVE	-	**Township and Village Enterprise**
VAT	-	**Value Added Tax**
ZBB	-	**Zero-Based Budgeting**

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ACKNOWLEDGMENTS

This report was written by a team including: Bert Hofman (team leader), Malcolm Holmes, Christine Wong, Zhou Xiaobing, Vargha Azad, Julia Li, Tamar Manuelyan Atinc, and Florence Parly (consultant). The report includes contributions by Jun Ma (IMF), John Norregaard (IMF), Heng-Fu Zou, Keith Mackay, and Maurice Gervais, and benefited from the comments of Vinaya Swaroop, Stefan Koeberle, Pieter Bottelier, Richard Newfarmer, William Allan (IMF), Russel Krelove (IMF) and the late Laslo Garamfalvi (IMF). Anne Green provided editorial assistance. Mmes. Leona Luo, Muriel Greaves, Meredith Dearborn, Grace Coward and Mr. Joseph Israel processed the report.

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The report was discussed with Government during a workshop in July 1998. The workshop was attended by Vice Minister Lou Jiwei, and officials from MOF, SAT, the State Council Reform Office, and others.

During the production of the report, the Sector Managers were Klaus Rohland and Pieter Bottelier, and the Country Directors were Yukon Huang and Nicholas Hope.

ABSTRACT

In China's emerging market economy, public expenditures will have a powerful impact on economic stability, social and economic development, and income distribution. China's continued success in these areas depends on how well it manages public expenditures. Achieving results with Government spending requires expenditure management that enforces fiscal discipline, directs spending to the Government's priorities, and ensures efficient delivery of public services. China's expenditure management does not yet meet these requirements.

Over the reform period, China has kept budget deficits low, and has shifted spending to priority areas, and the country shows impressive economic and social outcome indicators, such as high growth, and high health and education standards. But China's public expenditure management faces profound challenges:

- The retrenchment of the Plan puts more of the burden for macro and microeconomic policy on the budget;

- Extra-budgetary funds and quasi-fiscal operations of the banking system undermine fiscal discipline, which contribute to China's repeated bouts of inflation. The overall fiscal deficit has been much larger than the officially recorded 1-2 percent of GDP, and could add up to as much as 10 percent of GDP;

- Shifting spending to the Government's priorities is slow, and is in part undone during budget implementation. Many extra-budgetary funds may not support the Government's priorities at all. State Council priorities such as health, education, infrastructure and the environment are 4 to 5 percent of GDP underfunded, while SOE and bank restructuring put additional demands on fiscal resources. Over time, this could threaten sustainable and equitable growth;

- While overall social indicators are high, regional disparities remain large. And government services seem overstaffed compared to other countries, which could escalate costs if wages continue to rise.

To address these challenges, China needs to improve its public expenditure management. OECD reforms over the last 15 years have highlighted that changing the institutional framework–the rules of the game–for public expenditures is crucial for budgetary outcomes. Reforms focused on: rethinking the role of the State; shifting to multi-year budgeting; improving links between spending and policy priorities; and emphasizing performance in the public sector. The reforms paid off in lower deficits, more focused spending, and better service delivery. In designing its own reform program, China should realize that these reforms take substantial time, resources, and a strong high-level political commitment.

China's first priority is restoring fiscal discipline. Fiscal discipline requires including a significant part of extra-budgetary funds in the budget. However, Government should carefully balance the need for more supervision, and the incentives of budget units to deliver services and mobilize resources. Budgetary and extra-budgetary funds alike need better accounting, financial reporting, and treasury management. In addition, monitoring fiscal risk, and managing SOE guarantees and tax expenditures should reinforce fiscal discipline. But the most urgent task is to delineate a clear budget constraint for every line ministry and unit, and breaking down the sectoral budgets into organizational budgets is China's highest priority.

To forge a stronger link between the State Council's policy priorities and the budget, China needs to revamp its budget process. Building on ongoing experiments, China could: (i) develop a medium-term expenditure framework; (ii) take decisions on policy together with decisions on spending; (iii) require detailed budget proposals that establish the link between proposed spending and China's priorities; and (iv) develop capacity for evaluating expenditures on their impact on these priorities. More openness in the budget process, including a larger involvement of the various People's Congresses, would enhance the incentives for policy makers to deliver results. But perhaps the most crucial step for China to take is to integrate capital and recurrent spending in *one* budget. The State Development and Planning Commission should then focus on articulating the Governments strategic priorities, but leave detailed planning for achieving these priorities to line ministries. In the short term, China could already make much progress by requiring agencies to submit savings proposals along with spending plans; avoiding in-year approvals of additional budget requests; and phasing out spending increases prescribed in laws.

China's decentralized administration can be a major asset for cost-effective service delivery, if accountability for performance is improved. Beyond better financial management and audit, this requires better specification, reporting and monitoring of results of expenditures. Once accountability is established, more discretion for managers in allocating operating expenditures would improve results. China can further reduce the costs of public services by making wider use of the non-state sector through divesting from SOEs, relinquishing government direct control over many NPOs, and improving competitive bidding practices.

Continued reforms in intergovernmental fiscal relations are essential for better public sector performance. The large provincial share in expenditures demands a clear assignment of responsibilities and closer coordination with the provinces to achieve macroeconomic stability and better outcomes on State priorities. But regional disparities in service delivery will only diminish, if the experimental equalizing grants scheme is substantially expanded, and earmarked grants are better targeted to the poorer provinces and counties. Over time, local tax autonomy matched with increased popular participation is the single best guarantee for well-managed local expenditures.

CHAPTER 1
THE PERFORMANCE OF CHINA'S PUBLIC EXPENDITURE MANAGEMENT SYSTEM

Over the reform period, China has managed to keep budget deficits low, shift budgetary expenditures toward priority sectors, and achieve remarkable gains in social indicators, despite a drop in the revenue to GDP ratio. However, extra-budgetary funds (EBFs), quasi-fiscal activities, and in-year budgetary adjustments undermine fiscal discipline; priorities remain underfunded, priority spending gets diverted during the budget year; and high regional disparities in social indicators persist.

China's fiscal system has come under pressure over the reform period since 1978. The reforms initiated a major shift of the tax base away from the sources traditionally tapped by the tax system, and government revenues declined from over 34 percent of GNP in 1978 to less than 12 percent in 1996. This chapter reviews how China's budget system coped with the decline, in terms of maintaining fiscal discipline, meeting the Government's priorities, and delivering services efficiently.

Aggregate Fiscal Discipline

Budget deficits remained modest. China's key fiscal challenge over the reform period was to remain within the shrinking resource envelope. China's budget system therefore seems to have managed the declining resource envelope remarkably well. Government budgetary expenditures and net lending as a share of GDP declined in line with shrinking government revenues. Expenditures were less than 13 percent of GDP in 1996, well below that of comparator countries (Table 1.1 and Figure 1.1). This remarkable reduction prevented the budget deficits that caused much of the macroeconomic instability in other transition countries. Budget deficits have remained at a modest 1.5-2.5 percent of GDP throughout the reform period, with the exception of the 5.3 percent peak in 1979.

Bonds, reintroduced in 1981, financed a growing share of the budget deficit. Voluntary placement of bonds became feasible with the development of the secondary market in the early 1990s. People's Bank of china (PBC) financing of the budget deficit remained below 2 percent of GDP, except for 1979, and stopped altogether after 1994. Thus, China appears to have maintained an expenditure level consistent with macroeconomic stability.

Real expenditures increased. Fiscal adjustment appears less remarkable when *real* expenditures are considered. While expenditures declined as a share of GDP, they rose considerably in real terms.[1] Most governments would be envious of the 4 percent increase in real resources that China experienced over the reform period. If China had kept Government expenditures constant in real terms for only one year during

Table 1.1: General Government Expenditures

	Government expenditures as percent of GNP	Central government expenditures as percent of total expenditures
All countries	39.1	72.3
Industrialized countries	47.6	65.9
Developing countries	31.7	77.8
China (budgetary, 1996)	13.1	40.2

Source: MOF, Levin (1991), World Bankstaff estimates. Levin's data are from a sample of 18 industrialized countries and 22 developing countries for which data on general government are available in the International Finance Statistics. Data are averages over three years ending 1987 or 1988.

[1] The real expenditure numbers are calculated with the GDP deflator. This may be an underestimation of the true inflation cost of Government services.

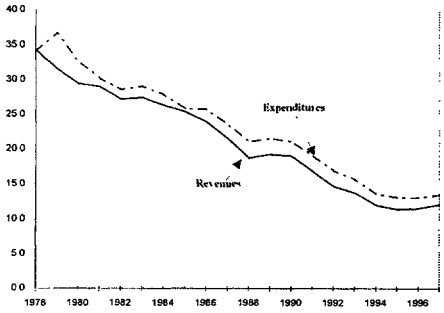
the 1990-95 period, it would have eliminated the budget deficit, a goal repeatedly expressed by the Finance Minister (see Annex 2).

EBFs rose sharply. Fiscal adjustment seems even less impressive, if EBFs are taken into account. These funds consist of surtaxes, levies and charges accruing to government and administrative units, and have grown rapidly from 2.6 percent of GDP in 1978 to over 4 percent of GDP in 1995, according to official statistics. A 1996 audit revealed that these funds could have amounted to over 6 percent of GDP, and later audits put the figure at 8-10 percent of GDP (Chapter 3). These funds are controlled by government, and have made up for part of the decline in budgetary resources. Social security funds, usually included in fiscal resources in other countries, added another Y236 billion or 4 percent of GDP in 1995.[2] With these funds included, overall government expenditures still declined from 37 percent of GDP in 1978 to about 21 in 1995, but in *real* terms, the annual increase averaged 6.5 percent. Moreover, 21 percent of GDP in government expenditures is much more in line with comparator governments' levels of expenditures.

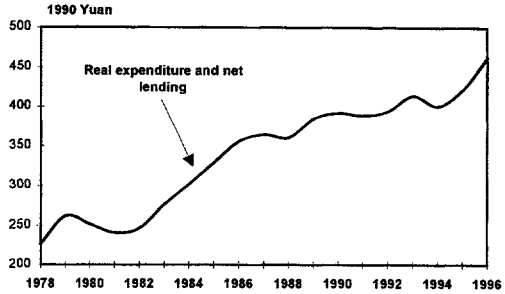
Quasi-fiscal financing is large. The decline in budgetary resources in terms of GDP forced China's government to resort to the banks for financing policy expenditures such as investment outlays and social expenditures of state-owned enterprises (SOEs). Much of this policy lending was directly or indirectly financed by the PBC: the PBC loaned to the State Banks, which in turn lent to SOEs. Conceptually, such loans are equivalent to

Figure 1.1: China's Aggregate Fiscal Discipline

China managed to keep budget deficits low...

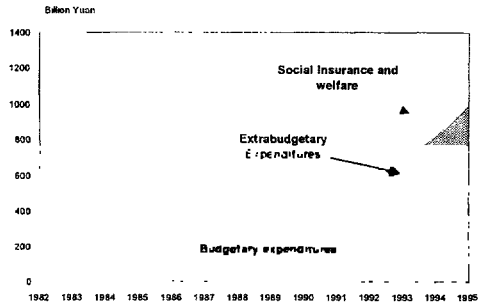


...but real expenditures rose rapidly

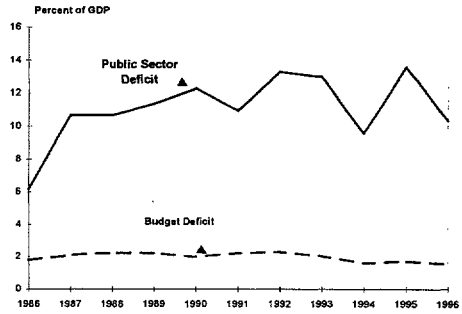


Note: Deflated with the GDP deflator. Wage deflator and RPI yield similar results.

....as did extrabudgetary and offbudget funds



and the public sector deficit remains high



* Extrabudgetary funds of government and administrative units

Source: MOF, Budget Speeches, IMF, Statistical Yearbook.

[2] State Statistical Yearbook 1997, p.747. Some double counting is possible as the budget provides limited contributions to these funds.

government net lending, and are usually dubbed *quasi-fiscal activities*. Thus, the government's financing requirement was significantly larger than the budget deficit suggests. The *Consolidated Government Deficit*, which adds the budget deficit and central bank policy lending, was estimated to average between 4.9 and 5.7 percent of GDP over 1985-1995.[3] The *Public Sector Deficit* that consolidates government and SOE borrowing is estimated to be 10.4 percent in 1996 and well over 10 percent on average between 1986 and 1995 (Figure 1.1). These deficits, and their partial financing by the Central Bank, have contributed to China's repeated bouts of inflation over the reform period.

Contingent liabilities could threaten budget discipline. The bank loans that financed the public sector deficit could become a government liability in the future. If a large number of SOEs are unable to pay back these loans, widespread bank failure could result, and may force Government intervention to protect depositors. Therefore, the non-performing SOE debt is a *contingent liability* for government. Official estimates put non-performing loans at about 20 percent of the banks' portfolio, or about 20 percent of GDP. Because China's loan classification does not follow international standards, reality is probably grimmer.[4] In a worse case scenario–, which is, still unlikely–government would have to bail out the banks, for example, by replacing the bad debt with Government bonds. If this occurs, government debt would increase by 20-percentage point of GDP, for a total of about 35 percent of GDP. Although this is still sustainable in light of China's high growth rate, a sudden increase in interest payments would require painful adjustments in other budgetary expenditures, or sudden increases in tax rates.[5] Moreover, if the banks turn bad, growth rates are likely to falter at the same time. Necessary tighter fiscal policy would add to lowering growth, which in turn could turn the Government's debt unsustainable.[6]

The pension system is another potentially huge fiscal liability. The current system for SOE employees is heavily underfunded considering present benefit levels, premium payments, and demographics. Some experts estimate that the "implicit pension debt" is over 50 percent of GDP.[7] Unless the pension policy changes, social security funds will run out of money, and government will face the awkward choice between accommodating the budget demands, or increasing premiums to a level that would severely damage labor market operations. Nevertheless, the pension debt is of a different nature than the bad debts in the banks, because it becomes due only over time.

[3] See Bert Hofman, Fiscal Decline and Quasi-Fiscal Response: China's Fiscal Policy and Fiscal System 1978-1994 in: *Different Approaches to Market Reforms: A Comparison Between China and the CEECs*, OECD/CEPII/CEPR 1997.

[4] Loans in China are not yet classified according to risk, borrower cash flow adequacy to service a loan, or to probability of repayment. Rather, the existing classification system is based on the number of days a loan is past due. All banks, under MOF regulations, are required to classify outstanding principal or interest as (a) "overdue" if payment has been overdue for more than six months but less than three years, (b) as a "collection loan" if overdue for more than three years, and (c) as a "bad loan" if it satisfies published MOF criteria. The amounts "classified" represent only the portion actually past due and not the underlying principal of the specific loan or the total exposure to a troubled borrower.

[5] Even if a government bonds issue is not necessary, a more gradual solution for the banks' bad debt is most likely to have fiscal consequences as well. For instance, banks could be recapitalized with increased provisioning for bad debts. However, this would reduce bank profits and therefore tax revenues. Alternatively, lending rates could be set such that banks generate more profits. However, this would reduce profitability of SOEs, the banks' main clients, and therefore reduce revenues to the budget as well.

[6] Broad conditions for sustainable deficits require the growth rate to exceed interest rate. These conditions may no longer hold, if growth suddenly drops. However, on the other hand, some taxes, such as excises on petrol, could be quickly, and easily raised, and could eliminate the deficit.

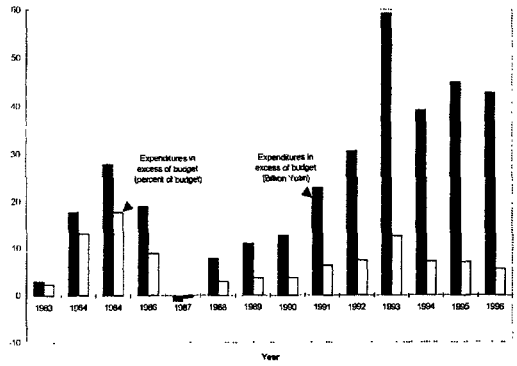
[7] See China: Pension System Reform, World Bank report No. 15121-CHA.

A budget that does not bind. China's budget does not constrain budgetary expenditures during the budget year. Since 1993, in every year but one, expenditures were higher than budgeted. In the mid-1980s over-budget expenditures could add up to almost 20 percent of total (Figure 1.2), but even as recent as 1993, excess spending was 12.5 percent of total. If Government had not spent beyond the 1995 and 96 budget, it would no longer have a budget deficit.

Strategic Priorities

Shifting Priorities. Over the reform period, China has gradually shifted budgetary expenditures from economic construction to public goods provision (Figure 1.3). Within the shrinking budgetary envelope, the expenditure composition changed considerably, reflecting economy-wide reforms. For example, the separation of enterprises from the budget caused a strong decline in capital construction expenditures. This decentralization of responsibility was crucial for achieving China's spectacular growth rates. Price

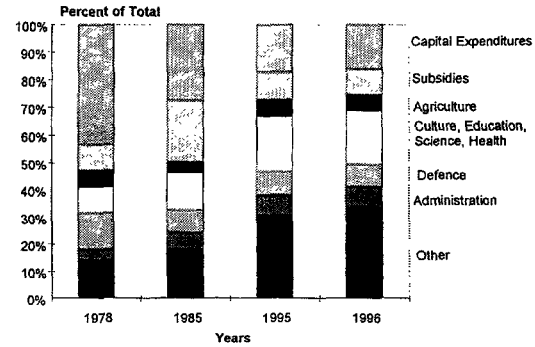
Figure 1.2: China's Nonbinding Budget
(In-year overspending, Yuan and Percent of budget)



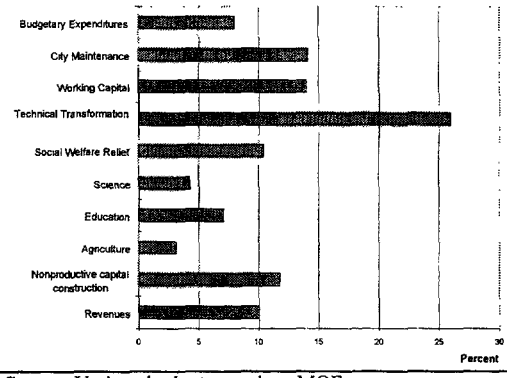
Source: Budget Speeches

reforms pushed up subsidies for daily living until the mid-1980, and after 1985, rising SOE subsidies feathered off the impact of producer price reforms. In recent years the budgetary share of both types of subsidies declined as consumer and output prices were aligned with market prices.[8] However, shifting spending can be slow: agriculture has been on the Government's list of priorities since the early

Figure 1.3: China: Strategic Priorities
Budgetary expenditures shifted to public goods
(expenditure shares 1978-1996, percent of total)



But strategic priorities get shortchanged during the year
(in-year overspending, percent of budget)



Source: Various budget speeches, MOF

eighties, but got a declining share of the budget until 1995. Similarly, despite the emphasis on infrastructure since the mid-eighties, spending only caught up after 1992.

Despite the shift in expenditures, priority areas such as health, education, poverty and the environment still remain underfunded. Provided that services are delivered cost-effectively, these areas may require an additional 4-5 percent of GDP in expenditures (Annex 3). Although such estimates can only be preliminary, they are

[8] Although the 1992-1996 inflation was combated in part by reintroducing consumer subsidies for grain.

probably in the right order of magnitude. Underfunding in these areas could, over time undermine sustainability and equity of China's growth. They also signal the problem that China cannot both finance its priority expenditures *and* eliminate its deficit, without reallocating expenditures within the budget, or taking revenue measures (Annex 4).

Whether EBFs have been reallocated towards Government priorities cannot be established. The accounting and classification system of these funds differs from budgetary funds, and reporting on these funds is often late and irregular.

In-year adjustment. Priorities get diluted during the budget year. All budgetary expenditures are substantially higher than budgeted, but there is significant differentiation among the sectoral increases (Figure 1.3). Priority areas such as education and agriculture get shortchanged during the budget year, whereas enterprise support through working capital and technological transformation expenditures benefited from in-year allocation of additional revenues.

Efficiency of Service Delivery

Remarkable outcome indicators. Outcome indicators for China's public expenditures look good in comparison with other countries at similar levels of GDP (Figure 1.4). Indicators such as literacy, infant mortality, life expectancy, and malnutrition are usually much better than those of comparator countries, suggesting relatively efficient service delivery in education, health services, and water and sanitation. Output indicators of these and other government services also compare well to other developing countries: primary and secondary enrollment rates, access to sanitation and safe drinking water, and access to paved roads are usually at levels similar to middle income countries.[9]

Uneven distribution. China's overall high standards in service delivery mask dramatic regional disparities. Beijing has the same infant mortality rate as France, but Qinghai and Yunnan are barely equal to Ghana or Bolivia. Similar disparities can be found in other health and in education indicators. Of course, public services are not the only factors in these outcome disparities: regional per capita income and large population of ethnic minorities are important factors as well.[10]

No sight on cost-effectiveness. Assessing whether China's government services are delivered at minimum costs is not possible with currently published data.[11] Not only is it impossible to aggregate budgetary and EBFs, and significant off-budget funds used for financing government services, but also publicly available expenditure classification reveals too little detail to break down expenditure by major program or by cost center and frequently even the Ministry of Finance (MOF) does not have access to relevant cost information.

Too many government workers? The scarce available data suggests that government services are delivered with high levels of labor inputs. Overall, some 5.3 percent of the population work for China's government, compared to 5.7 percent in the Organization of Economic Cooperation and Development (OECD) countries, 3.6 percent in developing countries, and 2.6 percent in Asian countries.[12] Overstaffing is quite striking in university education: China stands out with only 2.7 students per staff, compared to 21 in Korea, but only 38 percent of China's university staff

[9] See World Development Indicators, 1997; and China: Public Investment and Finance, World Bank report No.14540-CHA, October 1995. For a discussion of outcome, output, and input indicators, see: Pradhan, Sanjay: *Evaluating Public Spending*, World Bank Discussion paper No.323, May 1996.

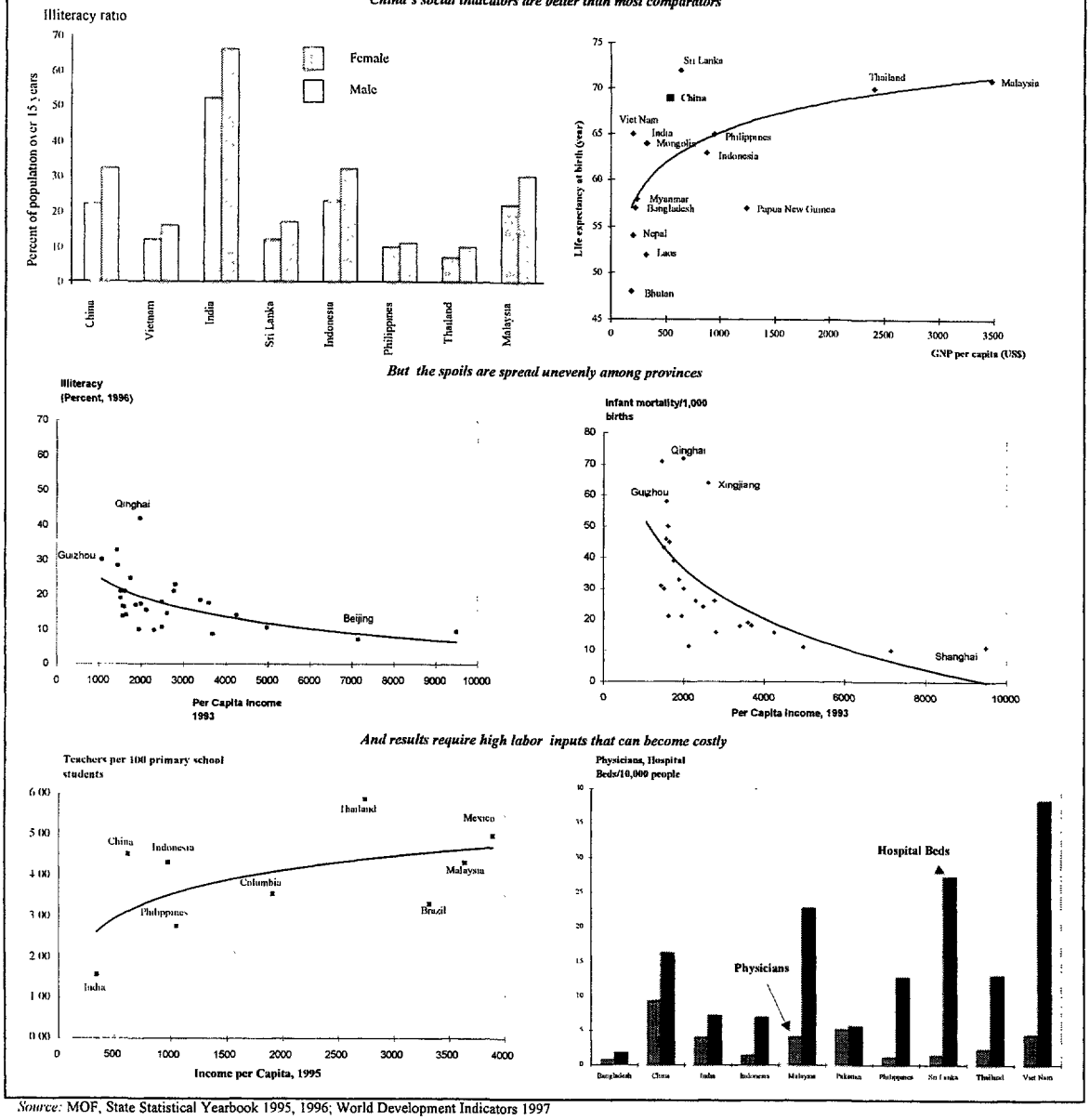
[10] See *China: Regional Disparities, World Bank Report -14496-CHA (Green Cover).*

[11] The mission that prepared this report had only limited access to non-published sources, not least because much of the relevant information was not reported to MOF, or because reporting formats did not allow for analysis of the data.

[12] See Sciavo Campo et al. *An International Statistical Comparison of Government Employment and Wages*, World Bank Policy Research Working Paper No. 1806, 1997.

Figure 1.4: China Efficiency of Service Delivery

China's social indicators are better than most comparators



Source: MOF, State Statistical Yearbook 1995, 1996; World Development Indicators 1997

Table 1.2: Student-to-Teacher and Student-to-Total Staff Ratios

	Full-time teachers as % of total staff	Student-to-full-time teacher ratio	Student-to-total staff ratio
China (1994)			
• Regular Higher Education	38	7:1	2.7:1
North American & European Universities	--	15-20:1	7:1
Taiwan (China) (1992)	75	21:1	16:1
Republic of Korea (1994)	66	33:1	21:1

Source: UNESCO, Statistical Yearbook 1995, pp. 1-30-1-51

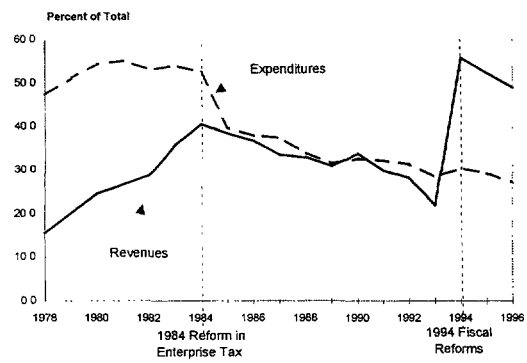
teaches (Table 1.2). The high staffing levels could in part be explained by relatively low wages that could make it economical to have low student/teachers and population/physician ratios. The total public sector wage bill in 1996 amounted to Y220 billion, or little over 3 percent of GDP, which is small by international comparison. However, wages are likely to increase more rapidly than GDP in the

future as nonmonetary benefits are monetized.[13] Some estimate these benefits to equal 50 percent of pay. Thus, the current input structure could become too expensive.

Decentralization and Public Sector Performance

The performance of China's public expenditure management system can only be fully understood with a thorough understanding of its intergovernmental fiscal relations (Annex 10 provides a detailed account). Central government's expenditure share declined for most of the reform period, as did its revenue share (Figure 1.5). In 1996, central government administered only 27 percent of all expenditures, and even after the radical 1994 reforms, received only half of all revenues. Central government's share is now much lower than in other developed and developing countries, particularly on the

Figure 1.5: The Center's Declining Share
(Central expenditure and revenue share 1978-96)



Source: MOF, Liu Zhongli 1997.

revenue side (Table 1.3), although part of the difference can be explained by China's vast size.[14]

Local governments receive the bulk of EBFs.[15] Over 85 percent is locally administered, most of it by the administrative units and institutions under local government. Social security funds are also locally administered, and pooled usually at municipal levels. Equally, revenues from land leases and SOE divestiture–funds not recorded in any published account–accrue mostly to local government.

Table 1.3: Central Government Share of Revenues and Expenditures in Selected Countries
(percent of total)

	Year	*Revenues*	*Expen-ditures*
Federal countries			
Australia	1995	76.6	59.0
Canada	1993	53.5	41.7
Germany	1995	73.0	59.2
Spain	1993	86.6	70.4
United States	1994	65.7	53.5
India	1993	61.8	54.7
Argentina	1992	57.2	55.1
Brazil	1993	71.4	65.7
Mexico	1993	84.6	78.3
Russian Federation	1995	60.0	62.4
Unitary countries			
Belgium	1994	94.8	88.5
France	1995	89.8	82.3
Netherlands	1995	96.3	76.4
Norway	1994	78.6	68.4
United Kingdom	1995	96.4	77.3
Kenya	1994	97.8	96.1
Poland	1995	92.1	83.8
South Africa	1994	91.4	66.3
Thailand	1995	94.9	92.6

Source: Ter Minasisan, T.:"Decentralizing Government" in *Finance & Development,* September 1997.

Local governments' large share in fiscal resources means that their expenditure management is decisive for China's fiscal outcomes. Local governments are not allowed to borrow, but their ownership of most of the SOEs puts much of the public sector deficit on

[13] Wages in China have lagged behind GDP growth over the reform period, and the official wage ratio of 20 percent of GDP is extremely low. However, much of workers' compensation is in the form of non-monetary benefits, such as low-cost housing, education, health care, and underfunded pension rights. If these benefits were to be monetized, a rapid rise in wages would be expected.

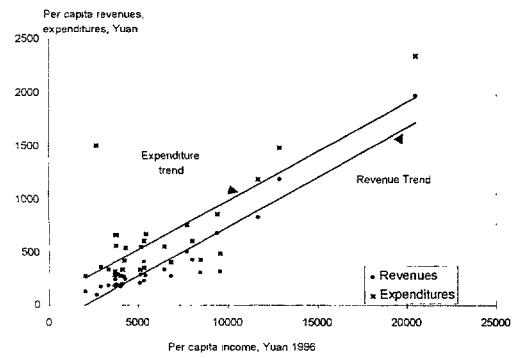
[14] See *China: Budgetary Policy and Intergovernmental Fiscal Relations* World Bank report 11094-CHA, July 1993. Over a sample of 39 developing and developed countries, and taking into account per capita income, urbanization, and size in terms of population or surface, China did not seem out of line with others on the revenue side, although the expenditure side was significantly lower than expected.

[15] The report follows the Chinese convention that designates all subnational governments as local.

their accounts.[16] In principle, the credit plan prescribes the overall-borrowing limit of SOEs, but in the past, local government pressures have repeatedly led to adjustment of the plan, and even unauthorized overshooting of the plan.[17]

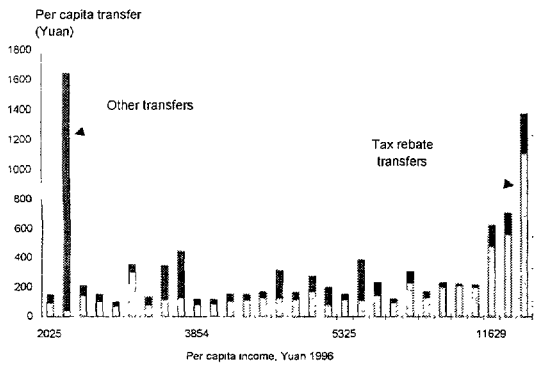
Figure 1.6: Expenditures Follow Revenues Follow Income

(Provincial per capita revenues and expenditures, 1996)



Unequalizing transfers

(Per capita tax rebate and other transfers, 1996)



Source: MOF.

The disparities in expenditure outcomes are closely related to the disparity in fiscal resources. Over the reform period, provinces relied increasingly on their own resources, and expenditures closely follow the highly dispersed revenue base (Figure 1.6). The reason for this is that–except for Tibet–transfers from central to provincial government do not benefit the poorer provinces. Most of the transfers are "tax return" transfers, a consequence of the 1994 reforms in intergovernmental fiscal relations. These transfers redistribute the increase of central tax revenues since the 1994 reforms to the provinces in which the revenues accrued. Thus, after Tibet, the richest province, Shanghai, receives the highest per capita transfer. However, other, more discretionary transfers, including earmarked grants and equalization grants, are not targeted to poorer provinces.

A View from the Top

China's policymakers are well aware of many public expenditure issues. Every year, the budget speech enumerates a variety of issues (Annex 2), which broadly cover each of the three aspects of public expenditure performance. The budget speeches regularly single out the rapid growth of expenditures, in particular administrative expenditures, and emphasize the need for increased macro control. The speeches express the need to readjust the pattern of expenditures towards priority areas such as agriculture, education and science, poverty reduction, and adjustment of the economic structure. Unfortunately, the failure to so, and the "diversion of funds" away from priorities is also a recurrent theme. Finally, each year the Finance Minister addresses the "extravagance and waste" and uncontrolled social consumption such as overseas trips and banquets, indicating that services could probably be delivered more efficiently.

Over the last two years, expenditure management reforms have become an explicit theme in the budget speeches, particularly the need to strengthen management of EBFs, and to "restore the financial order." These words have been matched by actions: the 1994 budget law has been a major step forward for budgetary management by clearly defining the roles and

[16] See *China: Budgetary Policy and Intergovernmental Fiscal Relations* World Bank report 11094-CHA

[17] See *China: Decentralization and Macroeconomic Stability*, World Bank report, October 1994.

responsibilities in the budget process. State Council Document No.29 of July 1996 has made a first step towards integrating EBFs in budgetary management. And budget speeches pay increasing attention to issues of social security and SOE reforms. These are promising beginnings.

However, this report argues that for fiscal policy to become a powerful tool for China's government–as it is for OECD governments–a more fundamental overhaul of the budgetary system is necessary. The OECD experience in budgetary reforms will be reviewed in the next chapter. Chapters three, four and five scrutinize China's budgetary institutions and recommend changes in China's budgetary framework that will deliver more fiscal discipline, achieve the government's strategic priorities, and increase the efficiency of service delivery.

CHAPTER 2
OECD EXPERIENCE IN PUBLIC EXPENDITURE MANAGEMENT REFORMS

Recent reforms in OECD public expenditure management reacted to rising fiscal imbalances and lagging public sector performance. The reforms have sought to improve macroeconomic and microeconomic aspects of the budget by better linking policy, planning and budgeting within a multi-year budget framework. Hard and predictable budget constraints and greater managerial autonomy matched with increased accountability have been decisive for better public sector performance.

The Background of OECD Reforms

Growing Governments. OECD reforms began against a background of concern over public expenditure growth, rising deficits and debt burdens, and a general disappointment with government performance. Governments had grown rapidly after World War II, backed by the belief that government could solve many of the macroeconomic ills of the prewar decade, and needed to mend many of the market's perceived failures. By the start of the 1980s, OECD governments spent over 40 percent of GDP on average, more than double the share of before the war (Table 2.1).

Table 2.1: The Growth of Government Expenditure, 1870-1990
(percent of GDP)

	Later 19th Century (about 1870)/a	Pre-World War I (about 1913)/a	Post-World War I (about 1920)/a	Pre-World War II (about 1937)/a	Post-World War II (1960)	(1980)	(1990)
Austria		..	14.7	15.2	35.7	48.1	48.6
Belgium	..	..	..	21.8	30.3	58.6	54.8
Canada	..	...	13.3	18.6	28.6	38.8	46.0
France	12.6	17 0	27.6	29.0	34.6	46.1	49.8
Germany	10.0	14.8	25.0	42.4	32.4	47.9	45.1
Italy	11 9	11.1	22.5	24.5	30.1	41.9	53.2
Japan	8.8	8.3	14.8	25.4	17.5	32.0	31.7
Netherlands	9.1	9.0	13.5	19.0	33.7	55.2	54.0
Norway	3.7	8.3	13.7	...	29.9	37.5	53.8
Spain	..	8.3	9.3	18.4	18.8	32.2	42.0
Sweden	5.7	6.3	8.1	10.4	31.0	60.1	59.1
Switzerland	.	2.7	4.6	6.1	17.2	32.8	33.5
United Kingdom	9.4	12.7	26.2	30.0	32.2	43.0	39.9
United States	3 9	1.8	7.0	8.6	27.0	31.8	33.3
Australia	.	...	..	...	21.2	31.6	34.7
Ireland	..	...	...	. .	28.0	48.9	41.2
New Zealand /d	..	. .	...	...	26.9	38.1	41.3
Total Average	**8.3**	**9.1**	**15.4**	**20.7**	**27.9**	**42.6**	**44.8**

/a Or nearest available year after 1870, before 1913, after 1920 and before 1937.
/b 1992.
/c Average, computed without Germany, Japan and Spain (all undergoing war or war preparations at this time).
/d GFS data, data available for 1960 is 1970, central government data only.

Source: Schuhknecht and Tanzi (1996).

Disappointing results. Much of the growth in expenditures resulted from social security, interest on rising debt levels and from government consumption, driven by rapidly expanding payrolls. Some therefore concluded that this expenditure growth contributed little to welfare (Schuknecht and Tanzi, 1996). The critics argued that increasing expenditure share did not "buy" more in terms of better outcomes of government policy: most of the economic and social indicators seem unrelated to government size. However, "Big Governments" perform better in income distribution and containing crime (Table 2.2). Higher spending on social security in these countries may also have contributed to lower crime rates in countries with larger governments. In addition, part of the increase in government expenditures can be explained by the lagging productivity inherent in government services, which automatically increases the government's share as income rises.[1] Nevertheless, the growing perception by the end of the 1970s was that government was the problem rather than the solution.

Table 2.2: The Size and Composition of Government Expenditures and Government Performance Indicators in Different Country Groups

	Industrialized Countries						Newly industrialized countries /d
	"Big" Governments /a		"Medium-sized" Governments /b		"Small" Governments /c		
	1960	1990	1960	1990	1960	1990	1990
Total Expenditures (percent of GDP)	**31.0**	**55.1**	**29.3**	**44.9**	**23.0**	**34.6**	**18.2**
of which							
Health	2.6	6.6	3.0	5.9	2.3	5.2	3.3
Education	4.5	6.4	2.9	5.6	3.4	5.0	3.4
Social Security	13.5	19.5	9.6	13.9	6.2	7.9	1.0
Research and development	...	2.0	...	1.6	...	2.0	...
Economic and Regulatory Efficiency Indicators							
Real GDP growth (in percent) /e	3.2	2.6	4.0	3.3	4.6	3.3	6.2
Gross fixed capital formation (in percent of GDP)	23.4	20.5	21.1	21.3	19.6	20.7	31.2
Inflation (in percent)	1.7	5.4	1.6	4.3	2.3	6.1	15.3
Unemployment rate (in percent)	2.9	6.1	4.6	9.2	2.7	4.2	2.9
Size of shadow economy (in percent of GDP) /f	4.9	11.1	3.8	8.2	3.5	6.2	...
Patents/10,000 population (inventiveness coefficient)	...	2.0	...	2.3	...	8.6	...
Social Indicators							
Rank in UN human development /g	...	11.0	...	13.0	...	6.0	...
Income share of lowest 40 percent	15.6	24.1	16.4	21.6	17.4	20.8	17.0
Illiterate population as percent of population 15+	9.3	2.9	13.3	4.6	2.2	0.5/h	9.2
Secondary school enrollment (in percent)	55.0	93.0	51.0	99.0	61.0	89.0	81.0
Life expectancy	72.0	77.0	70.0	77.0	71.0	77.0	74.0
Infant mortality/'000 births	23.0	6.7	29.0	7.1	22.4	6.4	9.8
Prisoners/100,000 people	...	38.0	...	68.0	...	154.0/i	...
Divorces (in percent of marriages contracted, 1987-91)	...	33.0	...	33.0	...	36.0	...
Emigration (in percent of total population) /j	0.6	0.2	0.3	0.8	0.2	0.1	0.1

/a Belgium, Italy, Netherlands, Norway, Sweden (public expenditure more than 50 percent of GDP in 1990).
/b Austria, Canada, France, Germany, Ireland, New Zealand, Spain (public expenditure between 40 and 50 percent of GDP in 1990).
/c Australia, Japan, Switzerland, United Kingdom, United States (public expenditure less than 40 percent of GDP in 1990).
/d Chile, Hong Kong, Korea, Singapore; 1990 or nearest available year.
/e Average of preceding five years, 1956-60 or 1986-90.
/f Most recent data available is 1978, used in 1990 column.
/g 1992.
/h US only. Others below 5 percent, UNESCO statistics for 1991.
/i Excluding United States, average is 64.
/j Data available for 1960 is 1970, data for 1990 may include 1993 in some countries. Newly industrialized country data, only Korea is available (1993).

Source: Schuhknecht and Tanzi (1996).

[1] This so-called Baumol effect argues that government would need an increasing share of GDP if productivity increases in government services lags behind that of other sectors of the economy.

Box 2.1: Earlier Budget Reforms in the OECD

Budgetary procedures had evolved from the end of the last century:

- *Line item budgeting* established previously lacked executive control over spending by ministries and agencies. In line item budgets, expenditures are listed according to objects of expenditures or line items, and focused on expenditure control, with MOF acting as controller. Line item budgets were not compatible with the expanding role of government. They gave no information on what the money was spent on or whether the money was used cost-efficiently or effectively.
- *Performance budgeting* introduced measures of workload and cost of activities into the budget. This increased the focus on cost-efficiency, but still lacked effectiveness information.
- *Program budgeting* introduced focus on trade-offs among competing goals. While performance budgeting focused on achieving a given goal at least cost, program budgeting treated the goals themselves as variables. Program budgeting requires the budget to be organized in groups of activities towards a certain goal, a program, and in addition required effectiveness and outcome measures. Program budgeting failed to become the main budget tool in part because the trade-off among competing goals could not be captured in the process, in part because the information required to make the trade-off was often not available because information systems did not support the budgeting technique.
- *Zero Based Budgeting* (ZBB), introduced in the 1970s, focused on the process of budgeting rather than the contents. In a pure ZBB system, all programs are evaluated from scratch each year. This pure form has never been introduced, but many governments have used the principles of ZBB, by requiring ministries to propose budgets with only 90 or 80 percent of the existing allocation.

The failure of performance, program, and zero-based budgeting to live up to their expectations was, in OECD countries, partially due to the high degree of centralization of the budget process that went along with them. As a consequence, the central ministries became overwhelmed with the paperwork involved in annual budgeting. In developing countries that introduced these or similar budget systems, the failure to address the generally disabling environment for performance in the public sector was key to the limited success.

Ineffective budgetary procedures. Budgetary procedures and practices in the 1970s contributed to expanding governments, and reinforced the perception that government was incapable of delivering results. Despite earlier reforms (Box 2.1), at the outset of the most recent reforms, OECD budgeting systems had all or most of the following characteristics:

- Primary focus on inputs, with performance judged largely by how closely spending matched budget appropriations.

- Short-term horizon for budget decision-making which failed to adequately account for longer-term costs and led to biased choices of policy instruments, for example between capital and current spending and between spending and regulating.

- Bottom-up approach to budgeting, which created strong upward pressure on expenditures. The arbitrary expenditure cuts in budget implementation that followed undermined program and agency level performance.

- Focus on distributing the fiscal increment across new spending proposals, and an extensive and detailed debate on existing spending, but little discussion of new and existing *policies*.

- Few incentives for agencies to save budgetary resources, because current year spending was the starting point for the annual budget haggle.

- Little clarity of purpose, task, and costs of policies, programs and services, and an intertwining in a single agency of policy advice, regulation, service delivery and funding.

In sum, the budget processes in OECD countries created a disabling environment for performance in the public sector.

Recent Reforms

The OECD countries have adopted varying degrees of reforms over recent years. Some, such as New Zealand, the UK and Australia, have adopted radical new approaches to expenditure management and public

administration. Others, such as Germany and Japan, have stayed much closer to the traditional, strongly bureaucratic model, which once dominated budgetary management in OECD countries. These differences are not surprising: budgetary institutions and organizations are deeply embedded in history and culture, and are not easily transferred from one country to the other. Despite the differences, common strands in reforms exist. Most prominently among them is the focus on achieving aggregate fiscal discipline, funding strategic priorities, and delivering services efficiently. Whereas earlier reforms had addressed each of these individually, more recent reforms have taken a more integrated approach and have recognized that these three levels of performance are inseparable.

The OECD reforms aimed broadly to:

- *better link policy, planning and budgeting* by: (i) increasing the scope of the budget to include expenditures for all government activities; (ii) adopting global budgetary targets; (iii) introducing a multi-year perspective to policy and budgeting; and (iv) focusing on strategic policy decisions at the center of government, while delegating implementation to implementing agencies; and

- *improve performance* by: (i) enforcing hard budget constraints of a comprehensive budget; (ii) creating agencies with more focused tasks; (iii) devolving managerial authority supported by better specification and measurement of performance; (iv) improving information systems and audit; and (v) introducing market mechanisms in the public sector. The main features of some OECD public expenditure management systems are summarized in Tables 2.3 and 2.4.

Linking Policy, Planning and Budgeting

The Scope of the Budget

Off-budget operations crippled financial discipline in various OECD countries in the 1970s. Implicit liabilities in social security systems and loan guarantees for (usually) SOEs often became explicit during economic recessions that also suppressed government revenues. Off-budget funds also undermined efficient service delivery, as agencies had recourse to alternate means of finance if they ran out of budgetary funds.

OECD budgets now include almost all expenses of government departments and their agencies, whatever their source of funding. Exceptions arise only when a law treats a particular agency as off-budget (Chapter 3). Social security funds may be separately managed, but they are normally included in the budget reports, and social security policy is included in annual budget deliberations. Most countries treat state enterprises only on a net basis, reporting taxes and subsidies in the budget. However, some–such as the UK and France–consider SOE borrowing during budget preparations, and report on public sector deficit and borrowing requirement.

Many OECD countries have increased budget coverage to include tax expenditures and loan guarantees. These are reported in the budget presentation or in mandatory regular reports to parliament, such as the "subsidy report" in Germany, which is issued every two years. New Zealand has the fullest treatment of "fiscal risks, "including contingent liabilities–claims against the government which will arise if a specific event occurs–and any event which if it occurred, would effect the revenues of the State.[2] In some countries, including the United States, there is a regulatory budget so that the costs on the community of regulations are made public.

[2] Underpinning the New Zealand approach has been a shift to a full accruals approach to budgeting.

Table 2.3: Public Expenditure Management in OECD Countries - *Linking Policy, Planning, and Budgeting*

	Australia	France	Germany	Japan	New Zealand	Unites Kingdom	United States
Strategic Goals/ Global Budget Targets	Commitment to zero budget deficit over the business cycle. Regular publications of fiscal outlook.	Medium-term targets in the "lois d'orientation' Maastricht criteria.	Financial Planning Council can set expenditure limits Currently: Maastricht criteria.	Reduction in bonds issue to below 5 percent of expenditures.	Move toward surplus in adjusted financial balance; reduce expenditures to GDP. Targets in Fiscal Responsibility act.	Expenditure growth lower than GDP growth.	Balanced budget by 2002.
Multi-annual Budgeting	Forward estimates (budget year and three outer years) central to budget process.	Experimental 3-year rolling plans, annexed to the budget documents.	Five-year rolling plans developed by MOF on basis of Financial Planning Council agreement, which coordinates policy with subnational *Laender*; included in the budget documents, but no legal or operational status.	No formal system of multi-year estimates. Medium-term projections included in Budget Document.	Three year projections of "baseline" based on previous year's numbers and Government decisions; issued to line ministries at the start of the budget process. Included in the budget bill. Outer year projections become baseline.	Budgetary policy set within Medium-term Financial Strategy, with key focus on borrowing requirement. Presented in Budget Documents. New Control Total drives multi-year expenditures.	Office of Management and Budget makes five-year projection, but no operational significance.
Salient Features of Budget Process	Cabinet determines overall expenditure limit. Expenditure review committee(ERC) considers policy changes, based on policy proposals and savings options. ERC sets sector ceilings for individual ministries. Ministries prepare sector budgets. Program management focuses on programs as the basis for resource allocation.	Prime minister sets sectoral and organizational expenditure limits based on MOF's internal projections. Budget proposals should in principle not exceed limits, but Ministries may appeal to Prime Minister.	Ministries submit proposals to MOF within limits set in budget circular. Submissions reviewed by MOF at various levels and in the Cabinet, which submits to Parliament. Two rounds of review in Parliament.	Centrally managed by the Finance ministry, Budget Office: Line ministries submit proposals to MOF on basis of a cabinet approved circular, and negotiate with MOF. MOF sends proposal to spending ministries, followed by new negotiations. Cabinet decides.	Output budgeting. Budget based on baseline estimate that includes policy decisions. Ministers make decisions on output purchases rather than spending. Spending ministries prepare appropriation estimates based on Cabinet output decisions.	Budget made within limit of control figures. Treasury invites "position papers" from departments, including spending increases that need to be matched with savings proposals. On basis of position papers, Cabinet decides guidelines for budget. Cabinet committee reviews ministerial proposals and proposes allocation of control figures. Cabinet approves.	Budget cycle divided in administrative and congressional cycle. Administration prepares on basis of OMB guidelines. Expenditures divided in mandatory and discretionary, the latter subject to legal limits on the deficit. President submits proposal to Congress, which, after a complex process, approves the budget.
Budget Year, Budget Calendar	July 1-June 30: Preparation January-June	January 1-December 31. Preparation January-December of previous year.	January 1-December 31. Preparation starts 13 months in advance.	April 1-March 31. Preparation starts in April of previous budget year.	July 1-June 31. Process starts July of previous year.	April 1-March 31. Budget process starts April of previous year.	October 1-September 30. Budget process starts 17 months in advance.
Expenditure Review	ERC has reviews available called for in previous budget round. All programs evaluated over a 5-year cycle.	No formal procedure. Court des Comptes (audit office) performs analysis.	Ad hoc reviews of existing policies. Biannual report on subsidies.	Efficiency and effectiveness reviews in budget process. Sunset legislation provides automatic review.	Annual budget cycle main vehicle. Ad hoc reviews of specific areas.	"Efficiency scrutinies" to lower costs; budget process forces to propose savings; Ad hoc reviews of major policy areas.	Evaluation of existing programs included in ministerial budget requests. OMB and CBO reviews of specific areas.
Powers of MOF or Treasury in Budget Preparation	Responsible for economic, fiscal and monetary policy. Manages the three-year forward projections drafts and proposes the budget; evaluates and reviews government programs and expenditure proposals; in charge of financial administration.	As in Australia, but with more detailed expenditure control.	Responsible for fiscal policy. Drafts and proposes the budget; evaluates and reviews government programs and expenditure proposals; in charge of financial administration.	MOF responsible for budgetary policy, tax administration, banking supervision, Fiscal investment and loan program.	As in Australia, but with more emphasis on scrutinizing budget proposals and administration.	As in Australia; recently some monetary policy responsibilities delegated to Bank of England.	Office of Management and Budget and Treasury have responsibilities similar to Australia.
Role of Parliament	No power to propose new policies; may amend the executives' proposal without increasing the tax burden, may refuse approval of budget.	No power to propose spending. Parliament may raise expenditures if others are cut	Unlimited powers to come up with new proposals or propose amendments to the executives' proposal.	Both houses of the Diet can make amendments and additions to expenditures proposed.	No power to come up with new proposal. Executives' proposals may be amended without raising the tax burden.	No power to come up with new spending proposals. Taxes and spending may be reduced, but not increased.	Unlimited powers to come up with new proposals and to amend executive proposals.

Table 2.4: Public Expenditure Management in OECD Countries - *Incentives for Performance*

	Australia	France	Germany	Japan	New Zealand	Unites Kingdom	United States
Performance Specification	Expected Outcomes and associated outputs included in budget documents.	Line item budgets. Ministry and Centers of Responsibility Contracts.	Line item budgets.	Line item budgets.	Output budgets, strategic plan, business plan.	Output Budgets.	Legislative requirement for strategic plan, agency performance report.
Budgeting for Operational Expenditures	Ministries/agencies receive single **running cost** allocation, which is formula driven, and requires efficiency dividend. No personnel limits on ministries and agencies. Possibility to shift resources between personnel and running cost, and between program.	not available	Unified personnel system for central and local government. Number of posts approved in budget. actual number determined by appropriation, but reserves can finance staff up to approved number.	Total Staff Number Law determines maximum overall staff. Cabinet order and budget determines staff numbers for ministries. MOF involved in salary budget preparation.	Allocations for outputs to be produced. Chief executives of ministries, agencies have authority to hire and fire. Limits set on chief executive salaries.	Personnel costs controlled by running cost system. Pay increases in principle financed from efficiency gains.	Total federal employment controlled; limits on number of senior staff.
Expenditure Control	MOF controls aggregate cash limits; expenditure controls responsibility of line ministry or agency; MOF provides accounting services; Single treasury account. Virement is possible between subheads and within running costs, however, this is not regulated by the law. Carryover up to 6 percent of running costs; capital expenditure may be carried over, however, this is not regulated by the law.	MOF issues warrants and checks in principle all expenditures, through Inspecteur de Finances. Recently has devolved some authority; single treasury account at central bank, encompassing regional accounts. Virement is possible within a limit of 10 percent of the appropriated amount. No provision for carryover.	Approval by MOF is required before disbursement; commitments can be blocked if a certain percentage of appropriation is spent; MOF and heads of agencies responsible for expenditure control. Single treasury account encompassing regional accounts. Virement possible within the same chapter, and between salaries and wages. Must be approved by the MOF. Investment expenditure and expenditure from earmarked revenue may be carried over.	Quarterly commitment and disbursement plans approved by MOF. Government consolidated account in Bank of Japan; subaccounts for line ministries. Virement within one item with approval of MOF. Among items with Parliamentary approval. Carryover automatic, if expenditures approved as "continues expenditures," If liability already accrued, or expenses already approved,	Departmental accounts in a commercial bank. Treasury clears the accounts every night, consolidates balances at the Crown Account in the central bank . The law gives MOF or Treasury a possibility to require any information, which is used as a base for a warrant system. Transfer allowed up to 5 percent from output to output, if no other transfer to the same appropriation has been made during the year and the total amount is unaltered. Spending authority lapses at the end of the year or as specified in the appropriations act;	Warrant issued by the Minister of Finance. The Treasury, and chief financial officers in agencies, ministries responsible for expenditure control. Single treasury account; paymaster accounts for ministries. Virement between subheads is possible but needs approval by the treasury. The Treasury has no power to authorize virement between votes or to meet additional expenditure with virement. Carryover for capital expenditures, and for	Warrant issued by the treasury. Office of Management and Budget, Treasury, and heads of department responsible for expenditure control. Single treasury account; Tax and loan accounts in commercial banks, on call for Treasury. The law has no provision for virement and carryover.

Table 2.4: Public Expenditure Management in OECD Countries - *Incentives for Performance*

	Australia	France	Germany	Japan	New Zealand	Unites Kingdom	United States
				with MOF approval.	no authority over five years.	meeting expenditures chargeable to that year.	
Budget Accounting and Reporting	Cash with accrual elements. Comprehensive budget documents and agency annual reports.	Cash	Cash	Cash	Accrual, Generally Accepted Accounting Principles	Modified cash, moving to accrual.	Cash based, with some accrual.
Audit	Financial and performance audits by the Australian National Audit Office, reporting to Parliament.	Inspecteur des Finances internal audit. Court des Comptes external audit, reported to Parliament.	Bundesfinanzhof performs financial and efficiency audits and reports to parliament. Relies on pre-audits by auditors in administration.	Board of Audit oversees audits and reports to Cabinet which passes on report to __.General Executive Bureau does the actual auditing.	Controller and Auditor General focuses on financial audit, control system audit. Regular performance audits. Reports to parliament.	National Audit Office does financial and efficiency audits. Reports published, and reported to parliament.	General Accounting Office performs audits, reports congress. At state and local levels, most audits performed by private firms.
Key Organizational Reforms	Cut in # of ministries from 28 to 18 in 1987.	Deconcentration to regional authorities.	N/A.	No new agencies unless an old one is abolished.	Separation of implementing agencies from ministries. Privatization.	"Next Step" agencies Privatization.	Privatization, deregulation.
Market-type Instruments	Increased user charging; key agencies have published client charters.	Public service charter.	N/A.	N/A.	Contract-based chief executive, state secretary; contracting out.	Contract based chief executives, Citizen's charter; contracting out.	Benchmarking; contracting out.
Main Legislation/ Documents for Public Sector Reforms	Financial Management Improvement Program.	N/A.	N/A.	N/A.	State services Act, Public Finance Act (1989) Financial responsibility Act (1994).	White papers: Financial Management Initiative Next Steps; Initiative; Citizen's Charter.	Chief Financial Officer Act; Government Performance and Result Act.

Sources: OECD 1993, 1995, Garamfalvi and Allan, 1997, World Bank,

Global Budgetary Targets

Since the later 1970s and early 1980s most OECD countries have adopted global budget targets in response to growing awareness of fiscal problems arising from lack of fiscal restraint. Many countries express these targets on a multi-year time horizon. Targets are usually either ratios (of expenditure, budget balance or debt to a national aggregate such as GDP); a rate of growth for spending (real or nominal); or an absolute value for a target variable (such as cash limits on spending or the size of the deficit). Some countries, such as the Netherlands, combined deficit targets with limits on Government's share of GDP.[3]

Global targets were questioned in the 1990s because they were thought to make the budget more pro-cyclical. Concerns were also raised that overzealous commitment to targets would lead to across-the-board expenditure cuts that budgetary reforms were designed to avoid. Finally, targets often invited creative bookkeeping on the part of government: in the drive to meet the Maastrich criteria, several countries have performed such tricks to reach the deficit target of 3 percent. One of the most creative ones came from a government that sold a state enterprise to a state bank and counted the revenues in its budget.

More recent approaches such as New Zealand's Financial Responsibility Act and Australia's Budget Honesty Act define global targets over the medium-term, and in terms that allow for the business cycle and external shocks. The strength of these approaches is the transparency associated with the regular publication of the medium-term fiscal implications of the government's policies.

[3] Actual OECD country performance in relation to targets has varied substantially due to fiscal shocks (e.g. German reunification), economic recession or change in political direction. However, fiscal balances in the OECD did improve in the decade after 1979, only to deteriorate in the economic slowdown of the early 1990s. More recently, the European Union members have seen marked improvements in their fiscal balances after adoption of the Maastricht treaty. This treaty restricts membership of a single currency to countries with fiscal deficits below 3 percent of GDP.

A Medium-Term Approach to Budgeting

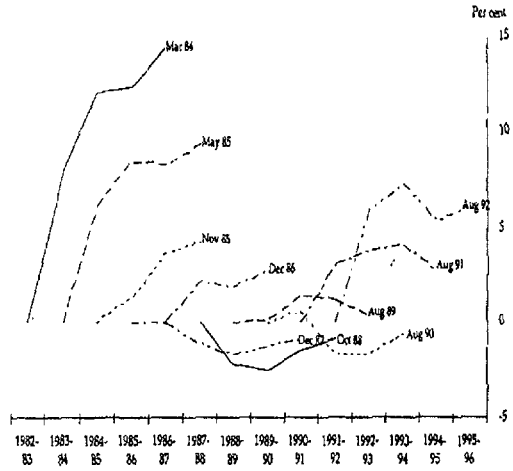
Global targets, whatever their form, are translated into annual budgets via their interaction with some form of baseline estimates of the cost of government policy over the medium-term. In OECD countries in the 1960s and 1970s, multi-year budgets were used as planning tools, sometimes in the hands of planning agencies with no responsibility for fiscal management. The total cost of the policies in the plan became the "global target," which was rarely constrained by a realistic assessment of what was affordable in aggregate. The plans and targets raised expectations which could rarely be met, and which led to many of the dysfunctional budgeting practices referred to above.

Beginning in the 1980s, more and more OECD countries adopted a medium-term expenditure framework (MTEF) in some form or another (Annex 6). A MTEF distinguishes between the medium-term costs of existing policies and a medium-term perspective on the level of sustainable spending. The costs of ongoing policy are determined by multi-year cost forecasts based on a detailed breakdown of expenditures for individual policies. Macroeconomic conditions, revenue projections, and the sustainable fiscal deficit determine the sustainable spending level. The difference between the sustainable spending level and the costs of ongoing projects is available for new policies. If this difference is too small, governments have to take decisions to drop existing policies, to raise additional revenues, or to refrain from starting new policies.

The MTEF provides policy-makers with the information needed to make decisions on new policies that could be accommodated within the expected resource envelope. The medium-term estimates are linked explicitly to annual budgeting so that annual budget limits are firmly based on the medium-term implications of government policy.

Australia's experience with the MTEF shows its potential power to regain fiscal discipline. (Annex 7). Introduced in the early eighties, the early projections showed an unsustainable trend in expenditures to finance existing policies. These projections forced policy-makers to make the choices necessary to reduce expenditure projections down to realistic medium-term targets (Figure 2.1). The forward estimates of the costs of ongoing policy came down from an unsustainable 15 percent in 1984 to virtually nil in 1990. Unlike earlier across-

Figure 2.1. Australia: Budget and Forward Estimates, Cumulative Real Growth



the-board expenditure cuts, the expenditure reductions were driven by decisions about dropping specific policies. Recently, several developing countries have adopted a MTEF, including South Africa (Box 2.2).

Strategic Policy Making at the Center of Government

In a medium-term approach, the challenge for policy-makers is to reconcile what is affordable with what is required. What is affordable comes "top down" whereas what is required comes "bottom up." Policy-makers need to reconcile the two by considering policy decisions together with their spending implications, rather than looking at policy and spending in isolation. Budgeting must therefore become focused on policy. The MTEF gave policy-makers the tools to determine what policies were affordable. Together with better incentives for public sector organization to spend money efficiently (see below), this allowed policy-makers to disengage from the day-to-day operations of government and to focus on policy.

Over the 1980s and 1990s ministers increasingly took control over strategic decision making and disengaged themselves from day-to-day operational issues. Policy-makers moved away from the sequential policy making outside the budget process, which had been an important source of macro instability and poor performance at the strategic and operational levels in the 1970s. Cabinets, often via a powerful sub-committee of key ministers, now focus on the trade-off between priority sectors and programs, within the macro framework discussed above. Governments of all OECD countries enforce–at least in principle–collective decisions within the executive.

Line ministries bought into the new budget processes because they gained much autonomy in making the policy trade-off within their portfolio, as long as they stayed within their budget limits. They no longer needed to negotiate with the Finance Ministry for additional funding, but could concentrate on designing new policies. And they had an incentive to reconsider existing policies, as savings could be used for new policies.

Evaluation. Policy discussions were supported by improved policy evaluation. The increasing interest in outcomes has seen a resurgence of comprehensive approaches to evaluation, the results of which fed into the policy discussion. Canada has had an evaluation system in place for many years. Australia has made evaluation an integral part of its budgeting process (Annex 14). Australia's approach is of particular interest because of its attention to the incentives for evaluation and the associated question of how to link evaluation results into the budget. In the Netherlands the reconsideration process, which involves annual policy reviews, has been

Box 2.2: Excerpts from the 1997 Medium -Term Budget Policy Statement in South Africa

Relationship with the budget. Government's spending plans for the next three years will be published in March 1998. These plans will give substance to Government's reconstruction and development commitments, within an overall level of spending that the nation can afford. These are the most important choices any government can make. The Budget must reflect Government's social and economic priorities, and its expenditure plans define the nature and scale of the Government's ambitions for the nation.

What is the Budget Policy Statement? This Medium-Term Budget Policy Statement sets out the policy framework for the coming budget. It describes Government's goals and objectives. It explains the economic environment within which those objectives are being addressed, and projects the total level of resources that will be available. The Policy Statement analyzes the trade-offs and choices that the nation confronts in addressing its reconstruction and development priorities.

The Medium -Term Budget Policy Statement is an important step forward in the budget process. In keeping with our commitment to open, transparent and cooperative policy-making, it invites the nation to share with Government the important choices that must be made.

The MTEF

Medium-term budgets. The key features of the new medium-term budgeting system are:

- publication of three-year forward estimates on Budget Day, consistent with Government's policy priorities and commitments;
- detailed analysis of the policy implications of budget projections;
- cooperative teams, composed of national and provincial treasuries and line departments, analyzing key sectors and reporting to Cabinet and Executive Councils;
- quantified, analyzed policy options presented to political office-bearers for decision; and
- the publication of a Medium -Term Budget Policy Statement, to enable Parliament and the institutions of civil society to participate meaningfully in the debate.

Rolling budgets. The MTEF initiates a process of rolling three-year budgets. The MTEF projections published on Budget Day will be considered again in the course of 1998, and revised according to new information and policy priorities. The three-year allocations will represent the starting point for that process, and departments will therefore have agreed spending trajectories within which to plan. Departments will be expected in future to frame their policy proposals within their three-year allocations. The introduction of resource-based planning represents a significant change in the planning environment and will initiate a major process of programme reprioritization and redesign within spending departments.

Public debate of plans. As in previous years, Parliament will be asked to vote only on the Budget allocations for the coming year, and not on all three years of the spending projections. But the detailed three-year spending plans will provide an opportunity for Parliament, the National Economic Development and Labour Council (NEDLAC) and civil society to evaluate the Budget allocations for the year immediately ahead in the context of the medium-term evolution of Government's expenditure priorities. Parliament will be invited to debate the expenditure plans, and to ensure that they reflect national goals and priorities. This process therefore provides new opportunities for all stakeholders to analyze and discuss the expenditure projections and to ensure that alternative views are fully taken into account in framing the subsequent MTEF.

The MTEF and budget reform

Overhaul of the budget process. The publication of the Medium-term Budget Policy Statement, and the publication in March of three-year budget projections, are first steps in a wider overhaul of the budgetary process, emphasizing transparency, output-driven programme budgeting and political prioritization. The MTEF provides the bridge between the technical preparation of budgets and the need to reflect political priorities in expenditure plans. Further steps in budget reform will be taken in 1998. These will include a transition to greater devolution of managerial autonomy, within a framework of improved incentives and greater accountability, accompanied by reforms of financial management.

Provincial and local governments. The policy goals of Government will be reflected not only in the national budget, but also in the budgets of provincial and local governments. Provincial and local governments will receive their equitable share of nationally raised revenues as well as other transfers. However, they have the responsibility of developing their own budgets, within expenditure allocations consistent with the nation's policy priorities. The national government does not control the details of these budgets, but can influence them indirectly through agreed policies and framework legislation setting norms and standards. The introduction of three-year budgets and their consolidation into resource envelopes for the major provincial services is an important step in the evolution of the institutional framework for intergovernmental policymaking and budget planning. The intergovernmental forums of the spending departments will, for the first time, have expenditure projections within which to develop and refine the norms and standards for service delivery.

Role of Accounting Officers. Once Parliament and provincial legislatures have approved their budget proposals, departments must adjust their expenditure to ensure that they stay within their budgets. It is the responsibility of Accounting Officers, appointed by political office-bearers, to ensure that allocations are applied to their intended purposes and spending limits are respected. This principle will be strictly enforced by the proposed Treasury Control Bill which is due to be introduced in Parliament next year, replacing the ten Exchequer Acts which govern provincial and national financial management.

Source: MOF.

Box 2.3: The Netherlands Reconsideration Procedure

The Reconsideration Procedure has been the main instrument of policy review in the Netherlands. It was introduced in 1981, and reviews existing policies in the public sector with the aim to develop more cost effective alternatives or to abolish the policy. The Cabinet decides policy areas for reconsideration. The departments responsible for the areas of review need to come up with savings options, including one that would reduce overall funding by 20 percent. The Sectoral department can use outside reviewers in the team to develop policy alternatives. The reports are made public by means of submission to Parliament. Savings proposals are reviewed in the normal budget cycle, but reconsideration can be initiated at any point in time. The reconsideration procedure is guided by a small ministerial commission led by the Prime Minister, the Vice-Premiers, and the Minister of Finance. MOF provides advice and administrative support for the reconsideration.

in place since 1981 and has played an important role in budgetary control (Box 2.3).

Transparency. OECD Governments differ on how systematic and transparent their strategic decision making process is. Some countries prepare and publish an economic and social strategy which sets out medium-term policy objectives expressed in terms of the desired social and economic impacts of policies, their expected fiscal costs and benefits, and allocation of implementation responsibility to ministers and agencies. Others are less thorough. All,-however, have some process for announcing their policy intentions and their relationship to budgets, and most use the budget speech. Openness and transparency in decision making increases the incentives for policy-makers to deliver upon their promises, or pay a political price if they fail to do so.

Budgets in OECD countries are widely published–more and more often on the Internet.

The role of the legislature. Decision processes in OECD countries are influenced by the nature of representative government. A system with significant distributed power such as the United States emphasizes processes for negotiation between executive and legislature. Others may require mechanisms for compromise because they have minority or coalition executives. The degree to which a legislature changes budget proposals of the executive varies widely in the OECD. In the US, Congress makes many significant changes, whereas in the UK Parliament invariably approves what the government proposes, because the proposal is that of the ruling majority. However, legislatures take an increasingly active role in budgetary policy.

Improving Incentives for Performance

The focus on strategic decisions at the center of government went hand in hand with major, and sometimes radical, reforms in the incentive structure for public sector units, broadly aiming at increased accountability for performance. The reforms granted more autonomy to government agencies and managers in implementing policies, clarified roles and responsibilities of organizations and government employees, specified the required performance, and improved monitoring of this performance.

Increased Autonomy

Managers in line ministries and agencies obtained increasing flexibility in using money to achieve policy objectives. Detailed central controls on line items or expenditure norms have been replaced by more aggregate controls, with greater flexibility at local levels to achieve agreed objectives within more global expenditure allocations. To this end, many OECD countries relaxed rules of virement and carryover. The medium-term approach to budgeting gave line agencies greater predictability of funding, which allowed better planning and allocation by public sector managers. At the same time, aggregate spending limits were strictly enforced by improved treasury management systems.

Box 2.4: Examples of Output Definitions and Costs in New Zealand

Provider	Police	
Output title	Custodial services	
Description	Provision of jailing services at police stations and courts for people under arrest or the subject of court orders. It includes escorting services to convey remand and sentenced prisoners to penal institutions	
Costs	$NZ 15,503,000	
Provider	The Treasury	
Output Title	Policy Advice: Taxation	
Output Description	Provision of advice on tax policy, including advice on international taxation, personal taxation, indirect taxes, business taxation, tax systems, and compliance	
Costs	International Tax	NZ$ 1,286,000
	Personal tax	NZ$ 562,000
	Indirect tax	NZ$ 201,000
	Business tax	NZ$ 2,171,000
	Tax system	NZ$ 468,000
	Ministerial services	NZ$ 271,000

Source :Purchase agreements between the Ministry of Police and the Commissioner of Police and the Minister of Finance and the Treasury; Quoted in Scott (1996).

Output budgeting. Most OECD governments still define budgets and control in terms of line items or programs. In contrast, New Zealand and the United Kingdom seek to hold organizations accountable for results in terms of the outputs they produce. While these countries acknowledge that outcomes are central, they reason that it is not possible to hold agencies accountable for ultimate impacts, because many other factors affect these outcomes, most of them outside the agencies' control (Box 2.4).

New Zealand went furthest in this approach, and abolished input budgeting altogether, to be replaced by output budgets and appropriation estimates. Within the limits of the appropriations approved by parliament, departmental managers have much freedom to allocate resources the best way possible to achieve the budgeted outputs.

Other countries without an output-based budget, have aspects of performance measurement in their accountability regimes. In Australia, resources are allocated by *programs.* Budget proposals for programs include a variety of performance indicators that establish efficiency and effectiveness. These indicators are regularly reported on and evaluated at regular intervals according to the evaluation plan. The United States' Government Performance and Results Act, passed in 1993, requires that five-year strategic plans linked to outcomes be developed by all federal programs by end 1997 (Box 2.5). By 1999, every agency is required to draft detailed agency performance plans, and integrate these plans into their operational and budgetary procedures. The Chief Financial Officer act requires that each agency be externally audited on effectiveness and efficiency.

Measuring Performance. The slow progress in developing reliable and monitorable outcome indicators confirms the inherent difficulties in this area (Box 2.6). Moreover, measuring performance requires not only measuring outputs, but also costs. Cost information collected on an output basis requires revising the chart of accounts, revising reporting formats and (ideally) adopting accrual accounting. Accrual accounting monitors the full cost of government activities, in contrast to the traditional cash accounting which registers only expenditures, but neglects depreciation, changes in asset position and accrued expenditures.

Personnel management. Countries such as New Zealand and the UK have extended performance contracting beyond the organizational level, and contract performance directly with the permanent secretary or chief executive. In France, a program for concluding

Box 2.5: Key Provisions of the Government Performance and Result Act of 1993

Agencies must submit to Congress, OMB, and President: **Strategic Plans** that cover at least five years and is updated at least every three years. First Plan due by September 30, 1997. Requirements:

- include a mission statement
- include general goals and objectives
- describe how goals and objectives are to be achieved
- describe how the general goals relate to annual performance goals
- identify key external factors that could affect performance
- describe program evaluation

Annual performance plans, first plan due to Congress at the FY99 budget request. Requirements:

- establish objective, quantifiable performance goals;
- describe operational processes and resources needed to achieve the goals
- establish performance indicators
- provide a basis for comparing program results to performance goals
- describe the means to be used to verify and validate results

Annual performance report, first report due to by March 31, 2000. Requirements:

- describe the performance indicators, actual results, and how they compare to performance goals
- review the success in achieving the performance goals and, if needed, explain why they have not been met, and what should be done
- describe any waiver of administrative requirement [an exception from legal requirements on an agency granted by Congress] and their effectiveness
- include summary evaluation findings
- show results for the preceding year

Source: National Partnership for Reinventing Government.

performance agreements with managers of certain well-defined activities has been in place for many years. Denmark has been implementing multi-year agreements linking budgets and performance. However, several countries which have experimented with detailed goal-setting for agencies have stopped short of setting individual goals in terms of outputs or performance, often because this does not fit well with the country's culture, or because the internal organizational culture is bureaucratic rather than managerial.[4] Some countries moved away from the strict limits on personnel numbers and salaries. In the UK and Australia, for instance, departmental personnel limits have been replaced by overall limits on running costs. At the same time, civil service career planning and training was enhanced for current and future managers.

Redesigning Organizations

Organizational reforms in some OECD countries have emphasized separation of functions into different organizations. These reforms promoted clarity and consistency of mission and removed conflicts of interest, such as a conflict between responsibility for the provision of service and the provision of policy advice on the same service. Examples of these organizational reforms include:

- *Sweden*, in common with other Nordic countries, has long separated Ministries from agencies with specific purposes.
- The *United Kingdom* in its Next Steps program has so far moved nearly two-thirds of the civil service into Executive Agencies charged with specific delivery functions.
- *New Zealand* has restructured most core government departments to separate policy from operations, purchaser from provider, regulator from operator and inspection from delivery.
- The development of *Canada*'s Special Operating Agencies, on the other hand, has been a limited initiative affecting only a few of the government's delivery functions.
- Similarly, in *France* there has been limited use of special administrative agencies outside the basic framework of the Ministries.

OECD experience suggests that reorganizing government can yield large efficiency and effectiveness gains, by establishing clear purpose and task; explicit performance expecta-

[4] See for example PUMA 1995c pp 176-179

Box 2.6: Outcomes, Outputs, Programs, Inputs

Increased performance orientation required improved performance definition and measurement. Performance has various dimensions, the usefulness of which depends on their purpose. For policies, and therefore for policy-making budget units, outcomes are the most relevant indicators; for service delivery units outputs are usually more appropriate.

Outcomes indicate the ultimate goals of Government strategies and policies. For example, education policies could aim for higher productivity and income for people; health policies could aim for higher life expectancy. However, productivity of people and life expectancy of people depends on much more than education and health policies alone. Policy research can narrow down what effect these policies have on the outcomes, but often not eliminate uncertainty on policy outcomes. The term *program* is used to describe all the policies, which a government has put in place to achieve a desired outcome.

Outputs specify the operational results of departments or other agents of government. For example, education could target 9-year compulsory education, and health policies could aim for full immunization of 5 year olds. These indicators are more specific, they often require *quality standards* to link the outputs with outcomes. A quality standard for education could be the percentage literacy and numeracy of 12 year olds; and for immunization the range of diseases inoculated for. Significant policy outcomes may be the product of several outputs together with direct budgetary payments and other policy measures such as regulation.

Input indicators show resources used in achieving outputs and outcomes. Traditionally, government accounts only registered cash outlays, but increasingly full costs are measured by including accrual elements in the government's accounting system. Other input indicators relate to actions taken to achieve certain goals such as the purchase of textbooks, the construction of hospitals and the hiring of teachers and doctors.

tions; the authority to perform the task and pursue the purpose; and which are accountable for the use of the authority provided.

Market Incentives

Improvements in the internal incentives for performance were reinforced by increased market incentives for the public sector.

Privatization. Over the last two decades, many services that were traditionally provided by the public sector were privatized in OECD countries. This trend started with utilities, but has expanded to infrastructure and telecommunication services as well. Besides a general backlash against government, the privatization was driven by changes in technology that allowed for private provision, and by the development of more sophisticated financial markets that could better finance large, complex and long-term projects.

Competition. The most direct external incentive is to expose government activities directly to competition. Differences among OECD countries' reform strategies are perhaps greatest when it comes to developing competition. Some countries have placed systematic introduction of market elements at the heart of their reforms. Other countries are still studying the extent to which they want to use them.[5] Besides corporatizing or privatizing market activities, OECD countries have used a range of devices to create or simulate markets for more core government activities. These include funder-provider models such as used in the UK and New Zealand for health services or in New Zealand also for science activities and some education; or voucher systems such as employed in New Zealand and the United States for low-income housing assistance.

OECD countries have subjected internal services to market disciplines by introducing user charging for internally provided services or exposing internal services to competition. In New Zealand most central services monopolies have been eliminated, and the users of these services are funded directly rather than funding the service. Most other countries however still retain a range of internal service monopolies.

Contracting out. PUMA reports that experience in the US and the UK with contracting out indicates substantial savings, but experience with contracting out relatively simple activities suggests several essential conditions for achieving real benefits, notably:

[5] PUMA 1995c p 45

- the existence of a competitive market amongst suppliers;
- open, verifiable procurement procedures; and
- solid skills in contract management.

These pre-conditions set practical limits to contracting out more complex activities in some countries; at least in the shorter term. And, as is the case for all market-type mechanisms, it is evident that potential improvements in performance can be dissipated if implementation issues are not given sufficient attention.[6]

The case for contracting out is strongest where the good or service required can be specified with a fair amount of precision, requires little specific capital to produce, and has a strong and competitive private market. Examples are computers, transport, cleaning services, building maintenance, minor capital works, printing and stationery and office accommodation. Some of these conditions may also apply to services such as legal advice and consultancy. Efficient choice between internal and external provision also requires the organization's accounting systems to provide the necessary cost information to set internal prices.

The United States has been focusing efforts on improving service delivery at central level through its National Performance Review (NPR) aggressively led by Vice President Gore. The NPR has led to a dramatic reform in procurement rules with much greater priority being given to value for money.

Competition surrogates. Where services are not contestable, as in the case of most core government services, countries have experimented with competition surrogates. Such tools are designed to increase responsiveness of the public sector organization and include:

- *Service standards*. The Citizens' Charter introduced by the United Kingdom has attracted widespread interest in other countries. Several countries (Belgium, Italy and Canada) have instituted specific public declarations of departmental standards of service. Others are considering them. In France, a report[7] currently before Ministers speaks of "putting citizens at the center of public service."
- *Benchmarking*. comparing the performance of an organization with similar ones elsewhere, or in the private sector, has been used as a tool to increase competitive pressures on public sector organizations.
- *User funding*. Rather than funding the public sector organization, its users can be funded. *Vouchers* are used in some countries' education system, funding the school which parents choose for their children, rather than the school directly. A national health insurance scheme that allows choice of provider works in similar ways.

The emphasis on responsiveness to citizens needs to be reconciled with formal organizational accountability upwards. Setting standards of service implies that departments will be accountable for achieving them. This in turn logically implies that budgetary decisions will take account of the outputs to which departments are committed. Further, a balance has to be achieved between client responsiveness and client capture. The public service is not seen to be directly accountable to its clients. Accountability to the public is indirect through the government and the Parliament.[8]

The Changing Role of MOF[9]

The role of the budget office in OECD countries has changed significantly over the

[6] OECD 1995 p 49

[7] Government of France 1995

[8] PUMA 1995c p 61

[9] This section draws heavily from Allan Schick, *The changing role of the budget office*, OECD Document No. GD(97)109, Paris 1997.

recent reforms. The traditional role of the budget office (usually MOF, although some OECD countries have budget offices separate from the treasury function) was to function as a central command and control post, specifying the items of expenditure, negotiating budget proposals with line ministries to control overall expenditures, monitoring compliance with regulation, and ensuring that inputs were used as agreed in the budget.

This role has changed in those countries that have undergone significant reforms. Managing the budget process is still the central role, but the way this role is operated differs from the traditional role:

- MOF is usually in charge of the multi-year forecasts: it either makes them itself (as in Australia) or manages the process by which line ministries make the forecasts. In the latter case, MOF provides the key economic data driving the multi-year forecasts, and guides ministries on how to assemble the forecasts.

- MOF usually manages the process of strategic policy choice. This no longer implies making allocation decisions during budget negotiations. Rather it means facilitating the process by which line ministries make trade-offs within the overall expenditure limit. MOF usually sets guidelines and procedures by which line ministries propose new policies and review existing policies.

- MOF's role in budget implementation has become one of monitoring and informing rather than control. Aggregate spending limits are still rigorously enforced, but line ministries have gained significant leeway in detailed spending decisions. In return, MOF's task is to ensure that resources are used productively. To this purpose, MOF has taken the lead in revising budgeting, accounting and reporting formats to match new concepts of performance and to ensure that this information is regularly reported.

MOFs in several OECD countries have taken a leading role in public expenditure management reforms. However, reforms have only worked in countries in which a broad commitment to reforms existed.

Conclusions

The OECD experience suggests that key elements of a performing public sector include: (i) hard budget constraints based on a multi-year perspective on the budget and enforced by internalized discipline of budgetary units (ii) results oriented institutional arrangements for decision making, resource allocation, budgeting, personnel management; and (iii) organizations which have clarity of purpose and task, clearly specified performance expectations, authority to perform the task and commensurate accountability mechanisms.

- Reforms are still ongoing, and some countries have only just begun. It is therefore too early to tell whether the reforms have been successful. However, the growth of government slowed in most OECD countries, and was even reversed in some. Deficits improved throughout the eighties, in particular in the forerunners of reforms, New Zealand and Australia, although a relapse occurred in the recession of the early 1990s. In the USA, in part due to an unusually long upswing in the economy, the large deficits of the 1980s have been eliminated altogether. But perhaps the most significant result of public sector reforms is a reassessment of the role of the state. At the end of the 1970s, government was seen as the problem rather than the solution. Now, the emerging consensus is that the state has a significant role to play in the economy and that capable states can do more and with better results.

CHAPTER 3
TOWARDS A MORE COMPREHENSIVE BUDGET

The rapidly growing extra-budgetary and off budget funds–now almost half of all government resources–undermine fiscal discipline, hamper funding of the government's priorities and give rise to wasteful spending. However, these funds have also served well to finance local initiatives outside the rigid planning system. China needs to better integrate EBFs into budgetary management, but should carefully balance the incentives for revenue mobilization, service delivery, and expenditure control.

Extra-Budgetary Funds

China's extra-budgetary funds (EBFs) comprise surtaxes, levies and user charges accruing to government and administrative units.[1] They were originally created in the 1950s to set aside small amounts of funds for the discretionary use of local governments, administrative agencies and enterprises. Examples of these early EBFs are a surcharge on the agricultural tax that was used for rural social expenditures, and a surcharge on the Industrial and Commercial Tax that was used to finance urban maintenance and construction. Rental incomes from public housing, users' fees, surcharges for public utilities were also counted as EBFs. All EBFs were earmarked for specific uses and were set aside from the budgetary process under decentralized management and allocation by different agencies and organizations.

During the 1980s EBFs grew rapidly with decentralizing reforms of the economy. Official statistics show that they grew from 2.6 percent of GDP in 1978 to over 4 percent of GDP in 1995. A 1996 audit found that EBFs totaled more than Y380 billion, or more than 6 percent of GDP, and far exceeding the officially reported amount.[2] Subsequent audits unearthed more unauthorized funds and fees at all levels of government. The best estimates now peg EBFs at 8-10 percent of GDP, but run as high as 15 percent (Box 3.1).[3] Local governments rely to a much larger extent on EBFs than the central government. Local

Box 3.1: "Would you like that with fees?"

McDonald's Restaurants in Beijing pay 31 fees on average, of which only 14 are legal, all this beyond the normal taxes due. With those fees, McDonald's supports not only the normal Beijing Municipal services, but also air shelter repairs, river cleaning, public festival decoration and communist party propaganda. The restaurant also pays for *not* having security guards–which is still cheaper than having one.

The illegal fees and fines and various apportioned charges that the many central, municipal, county, and township authorities impose on enterprises and individuals increasingly affect normal business operation, so much so that it is now seen as a deterrent for foreign investors. This has prodded the State Council to issue a circular on July 7, 1997: "On Abolishing Illegal Fees and Fines and Various Apportioned Charges for Enterprises." The circular orders that any illegal charges, fines, fund collections, foundation projects and other apportioned charges to the enterprises must be abolished.

Abolishing the fees is easier said than done, however, as repeatedly failed attempts to limit the taxing of farmers have shown. The key reason for failure to resolve the illegal fees is that, notwithstanding some excesses, many of the illegal fees pay for useful services, or pay the wages for civil servants that cannot be fired.

Source: China Financial Times, Asian Wall Street Journal, State Council

[1] Until 1993, EBFs included enterprise funds–retained profits, depreciation, technical renovation and welfare funds, which were at their peak as much as 80 percent of the total EBFs. The current definition of EBFs includes only "fiscal" EBFs–those accruing to governments and NPOs.

[2] MOF, SDPC, the State General Audit Agency, PBC and the Ministry of Supervision conducted the audit. See *China Securities* January 29, 1997.

[3] Officials from the MOF tend to cite the lower figures, while those from the State Administration of Taxation cite the higher ones.

used EBFs as *de facto* taxing mechanisms, a practice tolerated and even condoned by the central authorities.[4]

Although Government considers EBFs to be fiscal resources, they are managed separate from budgetary funds:

- The funds are allocated outside the budget process. Extra-budgetary allocation takes place when they become available.
- The funds are reported outside the budgetary reporting system. Reports on EBFs are infrequent and final accounts are only available more than a year after the budget year closes.
- The funds are managed through bank accounts separate from budgetary funds.
- The funds have a separate accounting system and accounting classification.

Other offbudget funds. Besides EBFs, China has numerous other off-budget funds. Most of these are not considered fiscal funds, and not included in the fiscal accounts, and some are not reported at all. Off-budget funds include:

- *Self-raised Funds*. Local governments and NPOs manage "self-raised funds, (SRFs)", comprising Township and Village Enterprises' (TVEs) profits and remittances, management fees collected by NPOs, rental income from collective assets, and the "unified levy" (tongchou) collected from farm households for financing rural education, militia training, road building, family planning and social welfare. In 1993-1994 SRF amounted to about 20 percent of total revenues accruing to township level governments.[5] Other SRFs include (illegal) local government bonds, "contributions" and outright borrowing from banks. Revenues from some state asset sales such as land leases have also been kept off budget.[6]
- *Social Security Funds*. China's social security funds are administered off budget at local level. Provincial pooling of pension and unemployment funds has started, but most funds are administered at municipal levels. At present, these funds run a slight surplus, but at current levels of benefit, the pension funds are seriously underfunded. Unemployment funds are also likely to run deficits, once SOE reforms will accelerate, and hidden unemployment becomes visible. Social security funds are reported in official statistics, but are not considered fiscal in China.

Tax Expenditures. Even less visible are China's numerous tax expenditures. A variety of industries receive tax exemption or tax reduction, in particular high tech industries, foreign invested enterprises, and enterprises in special economic zones. These deviations from normal tax policy have effects similar to expenditures: granting tax exemptions for, say, technology, means that less money can be spent for education. In the same vein, too much tax expenditures undermine the revenue base, and may cause budget deficits. Some estimate the total amount of tax expenditures to be Y100-150 billion in 1995.[7] Others have estimated that in 1994 tax reductions and exemptions to foreigners added to over 1 percent of GDP[8].

[4] For example at the township level off-budgetary resources are explicitly recognized for financing government–since their founding in 1986, township finance bureaus have been required to report receipts and expenditures of "three types of funds": budgetary, extra-budgetary, and SRFs. A State Council decree in 1991 explicitly permitted township and governments to impose a fee on TVEs. to finance agricultural subsidies, called the "using industry to aid agriculture" fee.

5. Ministry of Finance.

[6] The State Land Bureau estimates that over the past few years revenues from sales of land leases have totaled more than 25 billion Yuan nationwide, only a fraction of which were reported as fiscal revenues.

[7] *Source:* mission interviews. It is not clear whether the 1996 audit captured these revenues.

[8] IMF, Article IV consultations, annex to the report on Recent Economic Developments. The most important one is the exemption from import duties on import of capital goods by foreign funded enterprises.

- *Arrears*: Finally, regular reports on arrears appear in Chinese newspapers: teachers go without pay, and grain bureaus do not pay farmers for their grain. China's cash-based system does not capture these arrears, which make the budget deficit on an accrual basis larger than that on a cash basis.

An International Perspective on EBFs

Practically all OECD countries, developing countries, and in particular countries in transition have EBFs (Table 3.1). Some of these funds bear similarities to China's EBFs, but there are fundamental differences. OECD "extra-budgetary transactions" comprise all government transactions that operate outside the normal budgetary procedure. This exclusion can be at the *funding* stage (if budgetary revenues are set aside for a designated expenditure), at the *budgeting* stage (if financing is not fully determined by budget deliberations), or at the *funds management* stage (if EBFs are organized as accounting entities with own accounts).

Unlike in China, OECD EBFs need not be funded by earmarked or extra-budgetary revenues but can be funded from budgetary appropriations. Earmarking within the budgetary framework is commonly done through *special accounts*, which pool the revenue from one or more sources and is accessible only for specified expenditures.[9] These revenues and expenditures are subject to the normal budgeting procedure at the execution stage. The difference is their privileged access to the special accounts. Such earmarked funds protect funding within the budgetary allocation, but they do not protect the activity against revisions of the budgetary allocation from year to year. Annex 13 provides an illustrative example of earmarked funding of highway construction in the US.

Many OECD countries exclude some self-raised funds of agencies largely dependent on the budget from the budget allocation process and even from budgetary funds management. Examples are the Statutory Bodies in Australia, Crown Agencies in New Zealand, the *rechtsfaehige Anstalten* in Germany, and the *Etablissements Publics* such as museums in France. These public agencies are established under separate laws, and have budgeting and financial management rules separate from the budget law. Often, they have government representatives on their board. The budget only shows the subsidies to those organizations. Such organizations are not unlike SOEs, which are usually also treated on a net basis.

The Russian practice with many industry-specific EBFs comes closest to the Chinese situation, showing the common roots of the budget system. The Korean EBFs are also similar to the Chinese ones. In both Russia and Korea, however, the number of EBFs is far smaller than the 900 types of funds in China.

Minimizing Disadvantages of EBFs

EBFs can have advantages for certain types of expenditure (Box 3.2). However, often disadvantages dominate. Practices that tend to minimize the negative effects of extra-budgetary accounts (EBAs) include:

- EBFs should be constituted by law and respond to well-identified criteria, so as to avoid the unnecessary multiplication of EBAs. In France and in the United States, among others, law must institute EBFs, whereas in Russia they can be established by decree. In Germany and New Zealand, non-appropriated expenditures may be incurred

[9] In the United States, the budget includes several earmarked funds, which are denominated "trust funds".

Table 3.1: International Comparison of EBFs

	USA	Russia	Germany	New Zealand	France	South Korea
Types of Extra-budgetary Resources.	Two federal fiscal trusts funds: 1) Old age and Survivors fund 2) Disability fund	5 social funds. Technological development fund. 50 industrial funds (R&D, Investment, and Economic Distress funds) Directed state Implicit tax and credit subsidies. Cost recovery.	Social security fund. Unappropriated expenditures.	Unappropriated expenditures. Permanent appropriations for public debt and constitutional organisms.	Social security fund. Contingent liabilities Dependent organizations; ODAC.	Around 30 EBFs "Special-Budgetary Funds" (e.g. Grain Management fund, abolished 1994). Credit subsidies.
Revenue Source	Employers and employees contributions (payroll taxes)	Social fund: employers and employees contributions. Industrial funds: percentage of production costs or of sales.	Social security financed through employers and employees contributions and through budget transfers.	General revenue.	Social security financed through employers and employees contributions and through budget transfers.	Special funds financed by earmarked taxes, and transfer from budget special accounts.
Rules of EBF Constitution	By law	EBFs: by law or decree. Cost recovery: decision of the levying office. Direct loans: MOF decision	Unappropriated expenditures authorized by the MOF only under unforeseen and compelling circumstances, and either below DM10m or it is a legal obligation.	Permanent appropriations: by law. Unappropriated expenditures: maximum 1% of ministerial appropriation with authorization of MOF.		Established by law, with time limit, under the authority of a line ministry.
Budgeting (organ, integration with main budget)	The off-budget funds are included in the budget presentation. Unified totals are shown for expenditure, revenue, and deficit.	EBFs not included in budget document. Line ministries make budget of EBFs. Heads of agency decide on level of cost recovery public service.	Social funds prepare their own budgets. The budget includes only the flows to and from the social funds and the budget.	Completely integrated with budget.	Social security prepares its own budget, which is discussed during the budget session. The parliament can impose an annual spending limit. Unified total is presented as an annex to the budget document.	Budgeting done by line ministry, and approved by the president. Unified budget totals are presented with the budget document.

	USA	Russia	Germany	New Zealand	France	South Korea
Treasury management.	Social security funds manage their own accounts. but within the Treasury system. Treasury borrows at market rate from them.	Industrial funds: revenue should be paid to line ministries who distribute it. In practice, large portions are kept by enterprises and spent or kept in bank accounts.	Social security has its own accounts.	Permanent appropriation: same as for normal budget items.	Funds kept in a separate treasury account, managed by an autonomous agency (URSAF).	Fund kept in separate bank account under authority of line ministries. Treasury can borrow from surplus funds, after negotiating with the line ministry.
Transactions with budget funds.	Only limited financing from general revenue, for unfunded entitlements.	EB funds keeps their surplus, although, for industrial funds, part of surplus is kept by enterprises belonging to the fund.	Budget transfers of finance social security.	Not applicable.	Budget finances deficit of social security.	EB funds keep surplus or lend it to treasury; get budget funding or budget loan for deficit.
Accounting & consolidation with budget accounts.	No full consolidation with budget accounts.	No full consolidation possible with budget accounts.	No full consolidation with budget accounts.	Accounting: same as for budget. Full consolidation.	Separate accounting. No full consolidation of social security accounts with budget accounts.	EB Funds use commercial accounting system. No consolidation.
Reporting and Monitoring.	No reporting to Treasury.	No reporting to Treasury.		Same as budgetary items.	No regular reporting to treasury.	No regular reporting to treasury. Subject to the same external auditing practices.

only under exceptional events, and for limited amounts.

- The extra-budgetary resources should be kept under the authority of the Treasury, possibly with some special procedures to guarantee the priority of funding. This facilitates cash management, while assuring the regularity of funding for the extra-budgetary activities.
- Accounting should allow easy consolidation of EBAs with the budget accounts, and the central budgeting agency should have unrestricted and automatic access to the EBAs. If this is not feasible, at the minimum EBAs' totals should be added to the budget totals to provide a unified measure of public fiscal activity.
- Reporting and auditing requirements should be identical to those of the budget accounts. For example, non-appropriated expenditures are fully reported in the New Zealand Government financial statements.

Reforming China's EBFs

China's public expenditure management is severely weakened by the large and growing amount of EBFs and other off-budget financing. The large amount of EBFs fragments government resources; threatens aggregate fiscal discipline, and reduces incentives for agencies to operate cost-effectively.

State Council Document No. 29 (Annex 2) is an important first step towards a more comprehensive budget. The main changes under Document No. 29 are:

- It extends budgetary management to thirteen funds that had been treated as "below the line" items in the budget. These amount to a total of Y115 billion, out of a total of Y380 billion.
- It increases MOF supervision of the allocation and disbursement of funds.
- It shifts ownership of revenues collected under EBFS from the collecting unit to

Box 3.2: Pros and Cons of EBFs

EBAs are mainly used for activities which are to a large extent self-financing but which are not suitable for commercial provision, or whose provision the Government wishes to guarantee. The purpose of EBA accounts is to protect some activities from regular budgetary reviews of financial allocations, and to ensure the resilience of funding over time. The question is why certain expenditures should escape the screening and weighing process of the budget.

EBFs can be useful for :

- financing certain activities for which the public pays a price and expects a service in return. The budgetary decision process would delink price and service, by determining the price and the funding for the service independently. In this case, extra-budgetary finance is a specific form of earmarking. Social security or road maintenance are examples of such services. However, *individual* goods, such as electricity or water, are usually not financed through EBAs because they can best be supplied by profit-motivated enterprises.
- showing government commitments to a long-term moral or legal obligation, such as war veteran pensions, or the reimbursement of public debt. This gives rise to permanent appropriations which cannot be modified during the budget process, but require a different legislative process and sometimes constitutional amendments.
- responding quickly to expenditure needs arising from unforeseen events. Unforeseen events should be distinguished from risky activities such as government guarantees. The budget should account for the risks it assumes as a contingent liability, and budget for contingent expenditures.

The adverse effects of EBAs include:

- weaker macroeconomic management, by barring a comprehensive assessment of all expenditures and revenue, and hindering expenditure control. This in turn impairs the ability of the fiscal and monetary authorities to act consistently and incisively to ensure macroeconomic stability.
- increased rigidity of resource allocation, which affects policymakers' ability to fund strategic priorities.
- lower efficiency of service delivery, as they encourage overspending in those areas where (earmarked) revenue is plenty. Also, the lack of a comprehensive budgetary framework for EBAs can lead to the duplication of expenditure or taxes.
- looser financial control, as the lack of standardized accounting and reporting rules, and the complexity of transactions between the EBFs and the budgetary funds makes financial management intransparent.
- inefficient cash management, because idle balances are held in many separate accounts, thereby increasing the borrowing requirement of the government, and its interest payments. EBAs share with earmarked funds the property of increasing the rigidity of public resource allocation, and making it difficult to use the budget to implement strategic policy choices.

MOF and local finance departments. The comprehensive department is put in charge of managing these funds.

- It announces the intent to convert some "fees" to "taxes."
- It clarifies and sharply limits the authority for setting fees and levies, stipulating that only the central government can set up "funds", and only central government and provincial governments can levy fees.
- It eliminates the category SRFs at the township level and below and folds the funds into EBFs, while extending coverage of EBFs to include other non-budgetary revenues collected by township governments including various voluntary contributions, revenues from fiscal loan repayments, and interest from fiscal bank accounts.

With these changes, China has taken a decisive step towards consolidating budgetary management, gaining control over the aggregate spending level, and curbing the proliferation of funds and fees. In 1997-1998, MOF began a thorough review of existing fees and funds, abolishing some, reducing the rates of others, moving some into budgetary categories and excluding the business incomes of NPOs under government agencies.

In further integrating EBFs, however, the authorities face a delicate trade-off between incentives for service delivery and revenue mobilization by the spending units, and improved treasury management and expenditure control. Ignoring these trade-offs may result in a rapid recurrence of off-budget funds, as happened in the past. Notably, EBFs play an important role in funding local governments. Abolishing them, or reducing incentives to collect them by exercising too much central control may leave important services unfunded, or may force local governments to invent new levies and fees. Finally, many EBFs finance investments controlled by the State Development Planning Commission (SDPC), or finance the recurrent costs for maintaining and operating past investments. If EBFs are integrated in the budget, the coordination between planning and budget would have to be significantly strengthened (see Chapter 4).

For these reasons, reintegrating EBFs with the budget must be a gradual process with several difficult policy choices to make. In line with State Council Document No. 29, and building on the 1996 audit of EBFs, the authorities would need to review all of the hundreds of types of legal fees, levies, charges, and surcharges and decide whether to continue them as EBFs. Some of these funds, starting with the illegal ones, will be abolished. EBFs that are truly taxes, should be fully integrated in budgetary management, and treated as general revenues. Others, such as surcharges for specific goals, could remain outside the budgetary allocation process as earmarked funds, but would be fully integrated in collection, treasury management, reporting and audit. And finally, some user charges may be excluded from budgetary management altogether, and be used for funding commercialized NPOs.

In the short run, Government could focus on improved reporting and funds management of EBFs. Over time, emphasis should shift to consolidating the number of EBFs, and to simplify collection. Finally, the hard question whether Government has a role in the activities financed by EBFs should be tackled.

Improve funds management and reporting

- *Improving reporting.* A first step to improve reporting could be to allow the collecting spending unit to retain the funds, but to require them to present sources and uses of EBFs together with the budget proposals and budget reports, even if the National People's Congress (NPC) only allocates budgetary funds. During budget implementation, budget units should be required to report on EBFs as frequently as budgetary funds. Over time, the reporting system, and the accounting and classification of budgetary and EBFs could be unified.

- *Consolidate bank accounts and treasury management.* The supervision of remaining EBFs could be further improved by integrating the budgetary and extra-budgetary bank accounts of budget units. This would have to fit into a more general overhaul of treasury management and accounting practices in China (see Chapter 5), but already there seems to be few reasons for keeping separate budgetary and extra-budgetary bank accounts for expenditures, and for keeping separate disbursement processes.

Consolidate funds

- *Review taxes, levies, fees.* Many fees raised in China are truly taxes, and should be treated as such. Examples of this type include surcharges for rural education levied on urban building construction, and the education surcharge on the VAT and other turnover taxes. Revenues from user charges should remain with the collecting unit for financing the services for which they are levied. Revenues from taxes should go into general government revenues and used to finance the broad range of government services.

- *Consolidate remaining funds.* Consolidating the fees and funds into fewer items and categories should help simplify the payment structure and reduce the costs of collection and administration. Some of the surcharges on taxes could be integrated in the tax rate, others that have outlived their use could be abolished and replaced by the increasing general revenues. Reducing the number of collection units would reduce the taxpayers' burden of dealing with a multitude of collectors, and would reduce collection costs. For example, the collection costs for the township-unified levy, collected from farm households, absorb as much as 25 percent of revenues collected. Local tax bureaus can act as agents in the collection of most fees and charges at much reduced costs.

Reconsider the role of Government

- *Reconsider role of Government:* In reviewing EBFs, government would need to decide which tasks financed by EBFs are worth continuing, and worth continuing as government tasks. Divest the activities that are no longer considered government activities, either to the private sector, or to commercialized SOEs (see also Chapter 5).

- *Reconsider government organizations.* The review of EBFs needs to go hand in hand with a review of organizations within government. NPOs that are fully or largely funded by user charges might be better off as more independent units, or even enterprises. In some cases, this may require increases in user charges to cover long-term costs. Even some organizations that still depend on significant budgetary contributions could be better managed outside the budgetary framework. *The "Regulation on Financial Management for Non-Profit Making Entities"* of 1989 would need extension and revision to define a framework for such independent NPOs, including budgeting and financial reporting rules. Until such a revision has taken place, Government could consider treating NPOs as autonomous budgetary agencies governed by a contract that specifies revenue retention arrangements and expected performance.

- *Reconsider intergovernmental fiscal relations.* Because EBFs have become a major source of local finance, integrating them in the budget is likely to require adjustments in intergovernmental fiscal relations. If extra-budgetary levies are consolidated with the tax structure, a reassignment of tax revenues may become necessary. Alternatively, higher levels of government could consider earmarked

grants for the activities previously financed with EBFs.

- *Unify budgeting procedures.* Over time, for those EBFs that are truly government funds, budget procedures for budgetary and EBFs should be merged. Ministries and budgetary agencies would have to include the sources and uses EBFs in a single budget proposal. MOF's organization would have to adapt to the unified budgeting procedures. The Budget Law already allows for such an integrated budget. A first step in that direction would be to unify the accounting system for budgetary and EBFs.

A Halfway House?

For some of the EBFs Government decides to integrate further into the budget allocation process, the Japanese budget system might be a useful halfway house (Box 3.3). The Japanese budget separates the general accounts from 38 special accounts. The special accounts are financed by general revenues, earmarked taxes, and user charges, and are earmarked for certain uses. They are approved by parliament as part of the normal budget process, and managed throughout the treasury accounts at the Bank of Japan. However, the Japanese system maintains some of the disadvantages of the current situation in that significant parts of the budget are earmarked, and the system can therefore only be transitional.

How to treat other off-budget funds

Social Security Funds. Social security funds lend themselves less for full integration in the budgetary framework. However, reporting on these funds could be greatly improved. In most countries, public social security funds are reported together with the budget, and China should aim for the same. Together with improved reports on EBFs, this would establish a comprehensive reporting on General Government (Figure 3.1).

Contingent liabilities. Because contingent liabilities could greatly affect China's budget at some future date, regular review of the size of these liabilities is a priority. In OECD countries, reporting on these liabilities is far from comprehensive. New Zealand has the fullest treatment of "fiscal risks," including contingent liabilities–claims against the government which will arise if a specific event occurs–and any event which if it occurred, would affect the revenues or expenditures of the State.[10] Most OECD countries report on loan guarantees given, either by simply listing them, or, as in Germany, by budgeting for the likely default on the loans guaranteed.

To start reporting on contingent liabilities of the budget, the authorities could first make an inventory of possible liabilities that may accrue to the budget. Undoubtedly, those in the banking sector and in social security will constitute the bulk of it, but there may be more. China's policymakers would then have to decide for which liabilities they would have to or want to take on responsibilities. For those, the authorities would need to design reporting formats and reporting requirements. However, fiscal reports on the public sector are usually restricted to the public sector deficit. Statistical bureaus, together with the national accounts usually compile reports on the complete accounts of the public sector.

Tax Expenditures. The sheer size of China's tax expenditures and their similarity to expenditures necessitates a fuller reporting over these funds. Many OECD countries include reports on tax expenditures with the budget (e.g., the USA and New Zealand), or regularly present reports to Parliament (e.g.,

[10] Underpinning the New Zealand approach has been a shift to a full accrual approach to budgeting.

Germany's bi-annual *Subventionsbericht)*. For China, if not the NPC, at least the policy makers should be made aware of the resources foregone in giving tax reductions. They can then regularly decide whether the tax expenditures still match their strategic priorities. Over time, the Authorities should not only consider whether the tax expenditures still support their priorities, but also whether the instrument of tax expenditure is still appropriate for achieving the objectives, or whether others such as subsidies may be more appropriate.

Box 3.3: Japan's Budget: General and Special Accounts

The Japanese budget system might be a useful halfway house for some of theEBFs Government decides to integrate further into the budget allocation process. The Japanese budget separates the general accounts from 38 special accounts, grouped into 8 groups (Table)

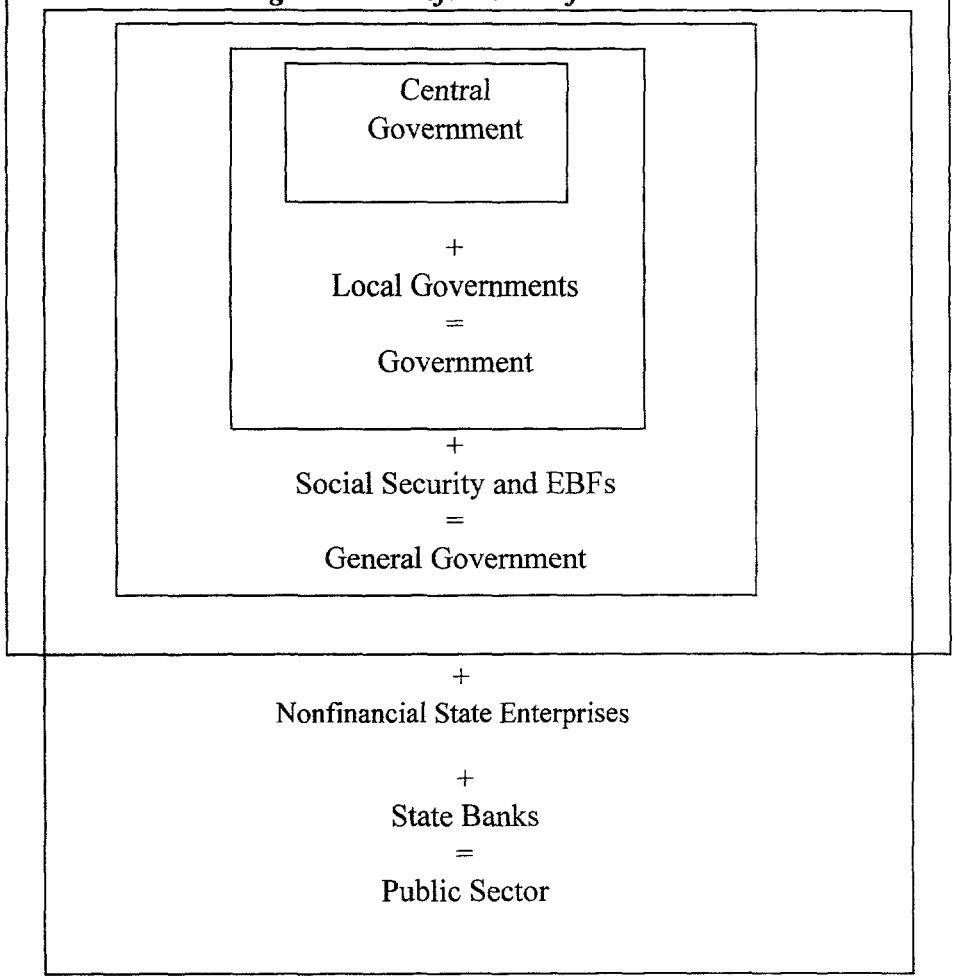
Box Table: Japan's Special Accounts

Type	Number	Explanation	Examples
The enterprise special account	5	To manage specific government administered enterprises	Mint Bureau, Printing Bureau, Postal Service
The insurance special account	11	(a) Special insurance, reinsurance, and social insurance that the private sector does not provide; (b) insurance comparable to private insurance	(a) welfare insurance, National insurance, labor insurance; (b) Postal life insurance, forest insurance
Special account for public investment	5	for certain public works	Port improvements, road improvements, flood control
Special account for administrative business	9	to manage administrative business, except insurance and public works	national schools, hospitals
Special accounts for loans	2	to manage the loan program to public corporations for specific purposes	industrial investment Urban development loan
Special account for fund management	2	to manage public funds established for specific purposes	Trust fund bureau fund; foreign exchange fund
The consolidated fund special account	4	to consolidate and account for revenues and expenditures for specific purposes	National debt consolidation fund; local allocation and transfer tax

The special accounts are established by legislation under specified conditions. These may be instituted when Government carries out specific projects, manages specific funds, or when it deems it necessary to administer some revenues and expenditures from the general budget. The special accounts are financed by transfers from the general account, user charges, insurance premiums, and loans from the fiscal investment and loan program, which captures the postal savings and some social insurance funds. Both the general account and the special account are reviewed and approved by Parliament as part of the normal budget process.

Source: MOF Japan

Figure 3.1: Definitions of Government



CHAPTER 4
LINKING POLICY, PLANNING AND BUDGETING

China's budget cannot yet play the more prominent role it will have in the market economy. Recent budgetary reforms and experiments are promising, but more far-reaching reforms should move China away from its current incremental budget process. MOF must bring a multiyear perspective in the budget, and forge a stronger link between strategic priorities of Government and public expenditures. The Government needs to reorganize its budget process such that policy and spending decisions coincide. It should require more detailed budget proposals, and build up evaluation capacity to ensure the funding of policies that support priorities. Better coordination between MOF and SDPC, and between central and local governments could help China to achieve its policy goals at spending levels compatible with macroeconomic stability.

When the Plan was the Government's main tool for implementing its policy priorities, the budget was the most important source for financing the plan. No independent fiscal policy existed. With the move to the market economy, the budget will become China's most prominent policy instrument, as the control over SOEs and Bank's diminishes.

Budgetary policy will, together with monetary policy, largely determine macroeconomic conditions for China. And the budget process will largely decide which Government policy gets funded and which not. In the transition to the market economy, China's budget should be agiled enough to take on new tasks such as providing social safety, while cutting back on old ones like financing. When EBFs are integrated in the budget, the budget will gain in importance for China's policymakers. But the budget needs retooling, before it can assume larger responsibilities.

China's Incremental Budget Process

China has a highly incremental budget process (Annex 1). The extensive amount of strategic planning and the explicit priorities of the State Council are insufficiently reflected in budgetary allocations. The incremental budget process undermines the Government's aggregate fiscal goals, fails to shift expenditures to emerging priorities, and dilutes priority spending during the fiscal year (Chapter 1). New and existing spending proposals are insufficiently scrutinized for longer-term impact on the budget, and on the policy outcomes desired by Government.

The macroeconomic framework. China's fiscal policy is anchored in the long term, 5 year, and annual plans. SDPC, with inputs from PBC, MOF, MOFTEC, SETC, and other agencies draft these plans. The long-term plan includes broad projections on the main economic indicators, and spells out areas of reform for the following 15 years. The five-year plans outline macroeconomic projections, including growth rates and investment rates, and the broad financing needs from budget and credit plan to finance planned investments. MOF compiles the five-year fiscal plan, which includes broad projections on revenues and expenditures. However, the plan has no operational function, and is not updated until the next five-year plan.

The annual plan for economic and social development provides the macroeconomic context for annual budget compilation. The State Council is in charge of formulating the plan, but SDPC does most of the work. In the fall preceding the budget year, SDPC forecasts economic growth of the coming year; MOF, SAT, and Customs project budgetary revenues, and MOF makes expenditure forecasts for the coming year. SDPC, PBC and MOF conduct meetings to discuss economic conditions, and SDPC and MOF negotiate the budgetary contribution to the investment plan. Future recurrent costs of investments are not taken into account in the budget. Problems with funding

budget. Problems with funding operations and maintenance have remained limited because most recurrent costs for investment projects have been financed from EBFs.

Non-binding fiscal targets. Overall fiscal targets play a small role in the budget process. The goal of the current five-year plan is to "basically eliminate" the existing budget deficit.[1] However, despite revenue increases of 10 percent or more (and 8 to 9 percent in real terms), the last two budgets made no progress towards this goal.[2] The target is already downplayed by the authorities: The Finance Minister stated in the March 1997 budget speech that "The deficit in the central budget is still so large that the objective of reducing the deficit set in the Ninth Five-Year Plan will be difficult to achieve."

Little focus on strategic priorities. The current budget process does not support a strong link between budgetary policy and strategic priorities. Its central purpose is to allocate the incremental revenues over new spending proposals: existing expenditures are hardly discussed, and the process is largely bottom up. A State Council Circular that starts the budget process includes general guidelines for expenditure increases. The circular gives some guidance per sector, but sectors are usually subdivided over a range of line ministries. No line Ministry therefore feels responsible for meeting the global or sectoral targets, and budget requests supersede the limits by a large margin.

Because of the lack of ministry-specific spending limits, much of the budget process is used for negotiations between spending ministries and the corresponding sectoral department in MOF. At this level, numerous policy decisions are made on the basis of whether additional funding is available, not on whether the proposed policies meet the Government's priorities. Decisions are referred to a higher level only when the working level cannot agree on spending. Some ministries see only 20 percent of their proposals for additional expenditures approved at the end of the budget process. The low approval rate is partially due to a negotiation strategy: overdemand for funds demonstrates the needs of the sector, and proposals that are turned down repeatedly have a higher approval chance in a next budget round.

The budget proposals of individual ministries lack sufficient detail to determine the links between the proposals and the priorities of the Government. A typical budget proposal would contain summary descriptions of new expenditures, and a table of expenditures on ongoing programs. Running costs for ministries and agencies, split up in "operational costs" and personnel costs, are separately budgeted for.[3] Budget proposals do not contain indicators for expected results. Output and outcome indicators are lacking, although sometimes spending proposals indicate the activity to be financed.

The focus on funding rather than policies is reflected in the annual budget speech. The budget speech lists planned and increased expenditure over the previous year. Few, if any concrete policies are announced in the speech, although it does mention some broad priorities ("support of agriculture, education"). The bulk of the text is devoted to spending levels on the various budget categories. This contrasts sharply with budget speeches in most OECD countries, which often announce major policy initiatives.

No Organizational Breakdown. A fundamental weakness of China's budget is that, apparently, no organizational breakdown of spending is approved by the National People's Congress (NPC). Although such a breakdown may exist in internal documents of the administration, the absence of firm spending limits per line ministry makes the sectoral budget limits nonbinding. The sectoral budget becomes a common pool for individual line ministries that operate in the

[1] It is debatable whether such a goal is appropriate for an economy growing with 9 percent per year. However, that is not the subject of this study.

[2] The budget speech has reported a sharply falling deficit, but this is the result of the exclusion of interest payments from expenditures.

[3] In fact, each ministry submits two proposals to different sectoral departments in MOF: one related to the ministries' expenditures and NGOs, and one related to State enterprise expenditures to the Trade and Finance Department of MOF.

Box 4.1: An In-Year Budget Request

Two months after the budget passed, a line ministry approached 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) 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's answer to the request could be as follows. First, the budget has just been passed, and 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.

sector, with little power on MOF's side to resist requests for additional spending (Box 4.1). A characteristic of well-performing budget systems in OECD countries is that the budget approved by the legislature (National People's Congress (NPC) in the case of China) sets firm limits on both administrative and discretionary program expenditure by organization.

Beyond the budget speech, little information is made public. NPC now receives a more detailed budget proposal–this information was restricted to the standing committee–but budget discussions remain behind closed doors. Most of these discussions take place in January and February, before the official submission to Parliament in March. The discussions with the standing committee sometimes result in changes in the final budget proposal submitted by the State Council.

Separation of Plan and Budget. The continued separation of the Plan–managed by SDPC–and the budget–managed by MOF–further dilutes focus on policy priorities. Although regular meetings between MOF and SDPC take place during budget preparation, for line ministries, the two institutions represent two sources of funds that need not necessarily be coordinated. Moreover, since line ministries do not present an overall budget, their accountability for the results of spending under either Plan or Budget is undermined.[4] Until there is a more effective link between investment decisions and the associated recurrent spending–with both driven by policy priorities–it will be difficult to assess what services are being provided to citizens and at what cost.

Little coordination with the provinces. The overall targets of the budget circular are not binding for provinces. The 1994 budget law requires approval of provincial budgets only by the local People's Congress, in contrast to previous central approval.[5] The central level only checks whether local budgets abide by national laws. Coordination does take place during the fall *finance and planning conference* where planning and budget policy is discussed, and provinces find out what level of central support they can receive. However, the agreements made are not binding, and only during the fiscal year do provinces find out what actual support is forthcoming. Similar to central levels, provinces are not bound by their approved budgets, as long as additional spending is financed with additional

[4] This topic is the focus of the report: *China: Public Investment and Finance, World Bank report No. 14540-CHA, Washington DC 1995.*

[5] This also contrasts with the practice of many unitary countries such as China, in which central government has the administrative means to restrict local government spending. However, China operates *de facto* much like a federal country.

revenues. Since local governments have no interest in macroeconomic stability, they willingly spend the extra revenue, and much of the in-year overspending is local.

China's murky division of labor among levels of government creates problems for implementing national priorities. China's unitary government leaves little *policy* responsibility to local government, but most of spending is local.[6] In practice, however, policy and administration are hard to separate, and the lack of clarity in responsibilities leaves policy priorities unfunded.

Budget year. The budget is not approved until well into the fiscal year. The fiscal year coincides with the calendar year, but since budget approval only takes place in March, the budget year is effectively reduced to nine months.[7] In practice, this means that some local spending units do not have their budgets approved until May of the current fiscal year.

Such late approval adds to uncertainty of funding at agency and local level, to the detriment of the ability to plan and deliver services efficiently.

In-year budget adjustment. Even after NPC approval, budgeting is far from over. MOF has a very conservative approach to revenue projections, and in every year since 1978 revenues have been more than budgeted, up to 18 percent higher in the mid-1980s, but in 1996 still 7 percent more than budgeted. This implies that some 40 percent of resources are allocated outside the regular budget process, assuming that the budget process only allocates additional revenues. For example, of the Y112 billion revenue increase in 1996, only Y64 billion was budgeted for in the NPC approved budget. The Budget Law prescribes budget adjustment procedures for such cases, but they have not been followed. For instance, the rule that additional expenditures should be financed from savings is never followed. The consequence is that in-year proposals do not compete with other proposals, and approval depends largely on the availability of funds. This practice–strongly encouraged by the absence of organizational spending limits–further undermines the link between policy priorities and funding. Also, the practice comes at the cost of Government's goal to eliminate the budget deficit: if all above-budget revenues for 1996 would have been saved instead of spent, the budget deficit would have been all but eliminated.

Lack of Fungibility in Extra-Budgetary Funds. EBFs are not budgeted for in an annual budget process, but are instead allocated, as they become available. According to the new procedures of SC circular 29, MOF has to approve the proposed expenditures. But the Comprehensive Department in MOF, not the Budget Department, approves the proposals outside the regular budget process, which is responsible for budgetary allocation. The lack of coordination between the two departments on the allocation of budgetary and EBFs further dilutes priorities. Thus, although many of the over 900 types of funds are likely to have outlived their purpose, the budget process cannot reallocate the resources. (Chapter 3).

Mandatory Spending Increases. The recent practice of approving laws with mandatory spending increases outside the budget process undermines fiscal discipline, while not necessarily improving budgetary outcomes.[8] Laws including expenditure provisions, such as the Education and the Agriculture law (Box 4.2) ensure spending increases in priority areas, but without detailing the policies the money is used for. In fact, the Laws undermine the incentives for agencies to develop effective policies and control expenditures, because they are guaranteed increased funding. Moreover,

[6] Article 107 of the constitution describes the *administrative* responsibility of local governments, but does not delegate *policy*. Article 107 states: Local peoples' governments at and above the county level, within the limits of their authority as prescribed by law, conduct the administrative work concerning the economy, education, science, culture, public health, physical culture, urban and rural development, finance, civil affairs, public security, nationalities affairs, judicial administration, supervision and family planning in their respective administrative areas.

[7] The budget law (Art. 43) allows expenditures not exceeding those of the previous year until the budget is approved.

[8] Thus contravening Art. 47 of the implementing regulations of the budget law.

Box 4.2: Mandatory Expenditure Increases in Laws and Decisions		
Function	Laws and Decisions	Spending Target
Education	Central Government Decision on Reform of the Education System, May 27, 1985 Compulsory Education Law, approved on April 12, 1986 and put into effect on July 1, 1986 General Guidelines for Education Reform and Development, February 13, 1993 Teachers Law, approved on October 31, 1993 and put into effect on January 1, 1994 Education Law, approved on March 18, 1995 and put into effect on September 1, 1995	4 percent of GDP by Yr 2000
Agriculture	Agriculture Law, July 2, 1993 Agriculture Technology Spreading Law, July 2, 1993	Spending growth higher than revenue growth
Propaganda and Culture	Central Government Decision on Some Important Issues of Strengthening Socialist Spiritual Civilization Construction, October 10, 1996	Expenditure Growth no lower than overall revenue growth
Science	Science and Technology Development Law, July 2, 1993 State Council Decision on Speeding Up Science and Technology Progress, May 6, 1995	Spending 1.5 percent of GDP by Yr 2000
Environmental Protection	State Council Decision, August 3, 1996	Spending 1.5 percent of GDP by Yr 2000
Health Care	State Council Decision, January 15, 1997	Spending increase not lower than revenue growth; per capita spending from Y2.6 to Y 4 by Yr 2000
Civil Service Wages	Civil Service Law, approved on April 24, 1993 and put into effect on October 1, 1993	Wages similar to SOE wages

priorities change over time, but laws are not easily changed, and the mandatory funding works much like EBFs.

The laws could threaten the Government's goal to eliminate the budget deficit at the end of the ninth five-year plan, because expenditure cuts in a growing number of areas become less feasible. Finally, mandatory expenditure increases apply to all levels of government, strain resources at local levels, and possibly force local governments to revert to illegal fund raising. It is ironic that the practice of mandatory spending increases, which is probably born out of frustration with the budget process, further undermines this very process.

Recent Budgetary Reforms

China has recently undertaken several steps to reform its budget system, focusing on the legal framework. The 1994 Budget Law, further detailed in the 1995 implementing regulations, specifies roles and responsibilities in the budget process, and restricts government borrowing from the Central Bank. The authorities have introduced a "Dual Budget" system, which separates recurrent and development expenditures, and further reforms aim for a separate Social Security budget and a State Asset budget.

Experiments with "Zero-Based Budgeting" (ZBB) aim to give increased attention to the policy contents of budget proposals and to all spending rather than the increase over the previous year (Box 4.3). However, the impact

Box 4.3: Zero-Based Budgeting in Hubei Province

To move away from the incremental base number technique, several local governments are experimenting with ZBB since 1993. ZBB puts more emphasis on the planned activities of a spending bureau rather than on last year's budget.

In principle all expenditure proposals are reviewed, not just the increment over last year. Expenditure norms for office expenses are included in the finance bureau's budget circular. The spending bureaus are required to put considerable detail on its "special projects" in the budget draft, which allows the finance bureau to probe the proposed expenditures more thoroughly, and to better assess the expected outputs of the bureaus. According to the local authorities, their budgeting practice also puts more emphasis on controlling personnel costs, as the more detailed budget proposals allow for a check of actual personnel rather than the quota of personnel assigned by the Personnel Bureau.

The local authorities state that the ZBB technique has enabled them to better control overall expenditures, control wage costs, and readjust expenditures in priority areas. However, they feel that the technique has its limits, because a large part of the budgets consists of personnel costs ("meal finance") which cannot be altered through the budget process.

of the technique is limited, because the format of the budget proposals in the experimental localities suffer from the same lack of detail as normal proposals, and fail to specify expected outputs and outcomes. Moreover, the Government's accounting system and the budgetary classification system provide policy makers with only limited information on the costs of budgetary proposals. Finally, personnel costs, which make up a large part of the budget, fall outside the budgetary process.

The MOF comprehensive department has been experimenting with a five-year rolling budget plan. The plan is not operational in the budget process, and is developed independently from next year's budget plan, in part because the information for the multi-year plan differs from that of the annual budget. No shared databases in MOF exist, and outside data for developing the plan are also transferred manually. Multi-year projections and annual projections alike are hindered by the absence of an economic classification of expenditures.

Making the Budget an Effective Policy Tool

If the budget is to become an effective policy tool, then the budget process should both discipline policy choices and translates the Government's policy priorities into expenditure decisions that meet those priorities most cost-effectively. The following proposed reforms show that this can be done by developing a MTEF, supported by changes in the budget process and institutions that link policy with spending. These reforms build on the experiments in multi-year rolling budgets and ZBB, and should result in an integrated approach to planning, policy, budgeting and evaluation, and the systems and procedures to support it. Figure 4.1 illustrates the planning and budget process (see Annex 4 for details).

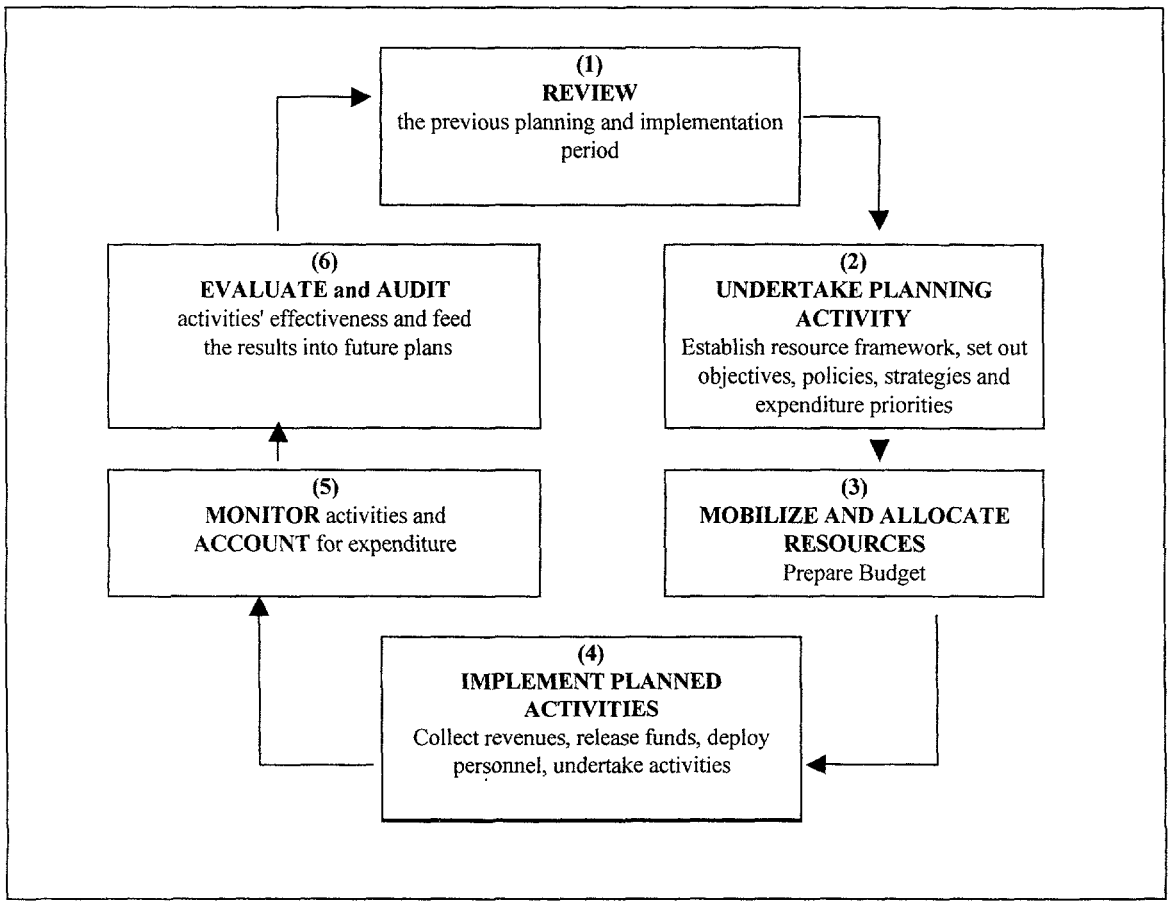
The proposed reforms are far reaching, and can only be implemented over time. China's approach to reform–gradual and based on experimentation before nationwide implementation–is well suited for the countries' decentralized budget system. However, OECD experience shows that budgetary reforms require strong and ongoing political commitment, and a change in culture within the public sector and with policymakers. Reforms only work if the resulting budget process disciplines policymakers in their decisions.

Ensuring Macroeconomic Consistency

Many policy decisions only have their full budgetary impact over time. To ensure spending consistent with the government's deficit targets and macroeconomic stability, China's budget system needs to move to a multi-year framework. Such a framework requires:

- Multi-year revenue projections based on macroeconomic conditions, and existing and future tax policies;
- Multi-year projections of sustainable or politically acceptable deficits;
- Multi-year expenditure requirements for funding existing policies.

Figure 4.1 : Linking Planning and Budgeting



In OECD countries, the above projections are usually captured in a document termed *fiscal outlook or policy framework paper.* This document, whether internal or public, serves to set the stage for budget preparation, and identifies the budgetary room available for new policies, or the need to cut on existing policies in order to meet the deficit targets. Macroeconomic consistency requires further:

- Expenditure limits that are set at the start of the budget preparation rather than at the end. The overall expenditure limits would be linked with macroeconomic conditions, revenue projections, the costs of existing policies and an acceptable deficit.

- Sectoral expenditure limits set at the start of the budget process based on policy priorities of the State Council. These sectoral limits would have to be broken down by ministry and agency for further detailed budget preparation, and should be included in the budget circular.

MOF's experiments with multi-year budgeting could become the basis for a multi-year expenditure framework that would ensure consistency of policy choice and macroeconomic stability. As a first step, the information base for the projections must be improved. In part this could be achieved by integrating the data used for the annual projection with those for the multi-year budget. Currently the Comprehensive Department, which is in charge of the multi-year projections, does not share data with the Budget Department that compiles the annual budget.

Second, sound multi-year projections require detailed knowledge on the composition of expenditures. The current budget classification and reporting system therefore need to be reformed. The system should allow for a breakdown by economic category, to enable analysis of the impact macroeconomic conditions has on ongoing expenditures. For instance, the budgetary consequences of an increase in wages, or rising prices for building materials should be easily traced. MOF should also be able to distinguish between statutory expenditures that are hard to change without changing laws, and discretionary expenditures that could be reallocated within the budget process. From the perspective of strategic priorities and operational performance, it is essential to also have a functional/programmatic classification to focus attention on policy priorities, their cost and implementation. A more sophisticated classification system could make such a distinction, and fully clarify choices for policy-makers.

Third, MOF needs to improve revenue projections, and extend them beyond the one-year horizon currently used. Most of the revenues come from taxes, for which SAT still makes projections. However, the MOF tax policy department is currently building the capacity that will improve revenue projections. To effectively integrate these projections in the multi-year expenditure framework (MYEF), these projections should be widely shared within MOF.

Expanding the experimental multi-year budget to a full-blown MYEF will require considerable capacity building in MOF and line ministries. Even if MOF is in charge, a MYEF can only become a credible vehicle for budgeting, if line ministries fully understand the process and agree with the estimates. As a start, MOF could include multi-year estimates in the budget documents, without operationalizing them as a decision tool. Over time, the estimates should become the starting point for the budget discussions. Enforcement of the overall spending limits resulting from the MYEF requires consensus on the policies that will be adopted within those limits. This requires revamping of the budget process.

Linking Strategic Policy Choice and the Budget

China currently lacks a mechanism that translates the broad priorities of the State Council into spending on policies that work. Such a link requires creating a step in the budget process that actually makes that link, more detailed budget proposals to establish that link, and more scrutiny of budget proposals to ensure the link.

Institutionalize the link of policy and budget. China could improve the choice among competing policy proposals by better integrating this choice within the budget process. Rather than leaving policy choices to low level officials during budget negotiations, China could consider making these choices in a high-level ministerial committee. One means of doing so is an *expenditure review committee*. Such a ministerial-level committee could, on the basis of the overall expenditure ceiling and the expenditures for ongoing policies, decide which new policies best meet the State Council's strategic objectives.

An expenditure review committee, or a similar body that links priorities with spending, could be in charge of breaking down the aggregate spending limits to ministerial and agency spending limits. Budget negotiations would then be restricted to checking whether the various ministries have indeed included the policy decisions of the expenditure review committee into their budget proposals. Since the ministries would be required to remain within their assigned spending limit, the endless negotiations on individual spending proposals could be abolished. Expenditure review committees (or inner cabinet or cabinet subcommittees) have been powerful tools aligning the budget with policy in countries such as the UK and Australia

The proposed expenditure review committee could have several sub-committees along sectoral lines, to overcome the disadvantage of the compartimentalization and narrow scope of the Chinese ministries. For instance, sectoral review committees for infrastructure, agriculture, and education, which would consist of ministers from those sectors, plus the Finance Minister.

As a second-best alternative to an expenditure review committee, a stronger link of policy and budget requires involvement of MOF in every policy proposal that will have budgetary consequences. This involvement should be, irrespective of whether the proposal is made within the context of the budget process, or whether the proposal is made during the year. Having the Finance Minister as a permanent member of the State Council would ensure that fiscal considerations are taken into account in policy decisions. However, a disadvantage of this approach compared to an expenditure review committee is that is would perpetuate the adversarial relation between MOF and all other ministries, because the Finance Minister would be the only one to ensure that aggregate fiscal targets are met.

Approve line ministry budgets. A necessary step for financial discipline is to break down the sectoral budget proposals into line ministry budgets. As a first step, the organizational budgets could be presented as an annex to the budget speech. But accountability would be greatly increased if each ministry would present its own ministerial budget to the NPC.

Make budget proposals more detailed. To achieve better links between strategic priorities and the budget, funding proposals need considerably more detail than at present. Ideally, each spending proposal would include:

- a justification for Government intervention, why the funding proposal is the best instrument of intervention, and why alternative intervention mechanisms (regulation, devolution to other levels of government) are not chosen (Box 4.4);
- the specific outcomes the policy tries to achieve, and their link with Government's priorities;
- the expected outputs of the policy, how they link with the outcomes, and how these outputs can be measured and evaluated;
- the specific instrument appropriate for the policy (produce the service; contract out to the private sector; subsidize an non-government organization (NGO) to deliver; fund the beneficiary directly);
- multi-year estimates of cost and expenditures for the policy, the required budgetary contribution, and the other sources of finance.

Build Analysis and Evaluation Capacity. To ensure that the policy proposals that are tabled in the budget process are sound, China would need to strengthen the government's capacity to analyze and evaluate budget proposals. Analysis of budget proposals should ensure that the proposed expenditures meet the Government's priorities, by funding those activities that give the outcomes desired by the State Council. Expenditure evaluation does the same for ongoing spending, and it can be a powerful tool for identifying savings options that would facilitate reallocation of budgetary resources to high priority sectors. Some capacity for analysis and evaluation already exists in the ministries, but the results of these efforts do not yet play a large role in the budget process. Much of the analysis and evaluation of policy would have to be done by the ministries themselves, but MOF can play a leading role in setting standards, defining procedures, providing training, and controlling the quality of the analysis. MOF could also jump start analysis and evaluation, by taking the lead in thorough analysis of budget proposals and evaluation of ongoing expenditures.

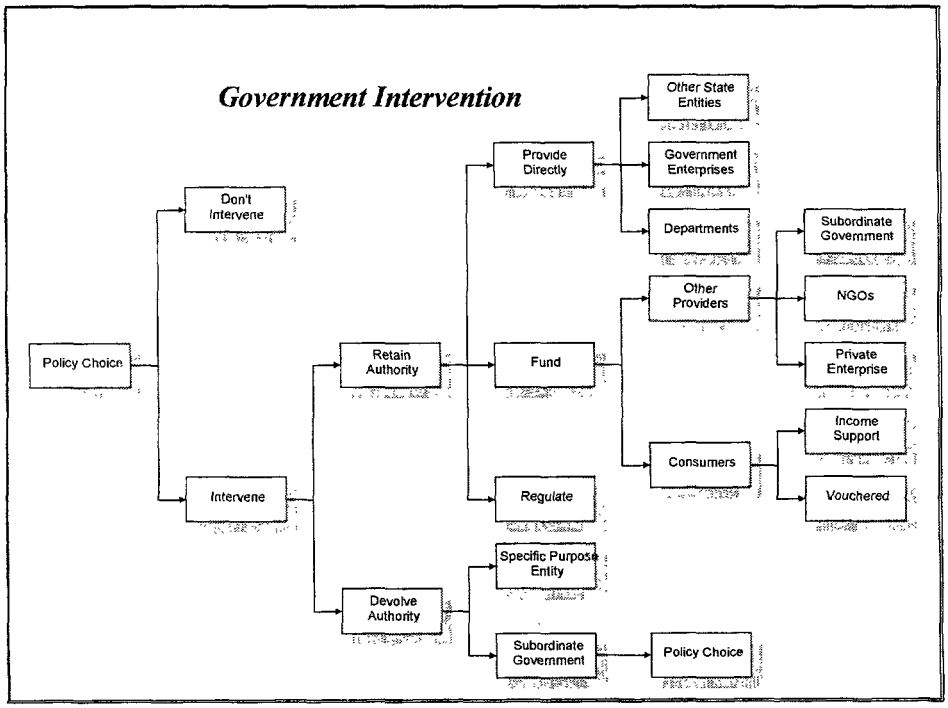
Ex-post evaluation can be supported by *value for money* audits of the China National Audit Office (NAO). The Audit Authorities still need to further build their capacity for financial

Box 4.4: The Changing Role of Government

Considerations on the role of government should become an integral part of the budget process and policy selection. At present, China implements most of its policies by direct provision through a department, an NPO, or an SOE, or regulate on a case-by-case basis, for example through investment approvals. This leaves many options hardly used.

In the move to market economy, China is likely to increasingly leave activities to the market by not intervening. And regulation of the market as a policy instrument will increasingly replace direct intervention. When markets mature, contracting out of services–either to SOEs or to private suppliers–becomes more and more an option. Finally, China makes as of yet little use of funding beneficiaries directly. The OECD reforms over the last decades show that widening the choice of policy options–including non-intervention–can greatly increase government's performance.

The budget process can be a powerful tool in reshaping the role of government: government is what government funds. By requiring that budget proposals include a motivation why government should intervene, and why it should do so by spending rather than by other means, the role of China's government can adapt in a gradual fashion to one more compatible with a market economy.



Source: Public Expenditure Management Handbook

audits, in particular if financial reporting by budgetary agencies would be expanded (Chapter 5). But over time, the NAO would have to increasingly focus on value-for-money audits, rather than only on the compliance audits as is done currently.

Over time, evaluation and value-for-money audits would have to become an integral part of the normal budget process. One way of doing so is by including evaluation plans in each budget proposal. But in the short run, China could choose to accelerate moving away from the inherited spending patterns. In the 1980s, several OECD countries have made a special effort in reviewing their existing policies (Chapter 3).

Improve Policy Coordination

Coordinate closer with SDPC. A better link between policy, planning, and the budget requires increased coordination among MOF and SDPC beyond the macroeconomic dialogue now taking place. The integration of EBFs in the budget makes such coordination even more urgent, as these funds now cover most of the recurrent costs for investments from the plan. As a first step, the multi-year

budget of MOF should be fully linked with the rolling investment plan of SDPC. This link would allow for budgeting for recurrent costs associated with investment projects. Such a link would also allow for better multi-year projections, and thus for more accurate determination of the resources available for new policies.

Second, since SDPC still plays the dominant role in formulating government's strategic priorities, SDPC should play a leading role in the expenditure review committee(s), once they are established. However, its role in detailed ministerial-level planning should diminish. To obtain ownership and accountability for the line ministry, sectoral planning should become the task for line ministries themselves. They should be responsible for formulating the policy initiatives necessary to meet the Government's priorities within the budget limits set by the expenditure review committee or a similar body.

Third, SDPC could gradually shift responsibilities for financial management of investment projects within government to MOF, and relinquish completely control over implementation of non-government investments.

Fourth, when over time the size of the plan has diminished, the plan could gradually be integrated fully into the budget presentation. SDPC could still present the overall strategic goals of Government to NPC, but the budget would include all financing and spending for Government, whether recurrent or capital spending. Line ministries could then present the detailed budgets for their organization.

Finally, in the long run, Government could consider merging MOF and SDPC. Korea, which had for 40 years a separate Finance and Planning Ministry, took this step in 1994. Japan, which has had a considerable dose of planning through the fiscal investment and loan program never had a separate planning and finance ministry, but combined these responsibilities in the MOF.

Coordinate within portfolios. China's policy priorities could be better served by budget proposals that cover the complete priority sector. Rather than having the ministries of agriculture, water resources, and forestry each submit its own proposal to MOF, their proposal could be merged into one covering all of agriculture. Similar considerations hold for the transport sector, which is carved up between the ministries of railway, construction, and communication. Subcommittees of the proposed expenditure review committee could be instrumental in formulating such unified proposals for a priority sector.

Over time, and in line with the ongoing civil service reforms, ministries could be merged or even abolished. This would not only bring China's government administration more in line with the emerging role of the state, but also in line with its policy priorities. Merging would facilitate better trade-off of competing policy choices within the priority sector. For instance, the ministries for agriculture, forestry, and water resources–each involved in agricultural policy–could be merged to emphasize the priority government puts on that sector, and to better allocate the increasing resources for that sector. The announced reforms already make a big stride in abolishing those ministries directly involved in productive activities (Box 4.5).

Coordinate better with provinces. China's highly decentralized fiscal system requires effective macroeconomic coordination with provinces. Such coordination would gain in importance once provinces will be allowed to borrow from the capital market–currently prohibited in the budget law. But even without borrowing, the provinces' procyclical spending has macroeconomic consequences. China therefore needs to consider coordination mechanisms that are more effective than the current planning and finance conference. Of

interest are the models of Germany and Australia, which coordinate with subnational governments in a multi-year framework (Box 4.6). As a minimum, effective coordination requires:

- working on a common set of assumptions on key macroeconomic variables, including growth rates, prices, inflation, relative price changes, wages and exchange rates;
- working with common revenue and expenditure classifications;
- producing budget forecasts early on, and well in advance of the budget year, so that thorough discussion can take place, and the benefits of coordination can be integrated in the final budget proposals.

Beyond the macroeconomic framework, increasing policy coordination at the strategic level could more effectively link the State Council's priorities and the budget. The Finance and Planning conference comes too late in the year to have a meaningful impact on budgetary decisions, and additionally policy coordination among levels of government is called for (see also Chapter 5).

Move Away from Incrementalism

Improving the link of strategic policies and the budget process will take considerable time. However, much scope exists for China to further move away from incremental budgeting in the short run. Measures that can be taken include:

BOX 4.5: OUTLINE OF CHINA'S GOVERNMENT DOWNSIZING

China's government downsizing approved by the National People's Congress:

MINISTRY-LEVEL BODIES TO BE ELIMINATED
Ministry of Power Industry
Ministry of Coal Industry
Ministry of Metallurgical Industry
Ministry of Machine Building Industry
Ministry of Electronics Industry
Ministry of Chemical Industry
Ministry of Internal Trade
Ministry of Posts and Telecommunications
Ministry of Labour
Ministry of Radio Film and Television
Ministry of Geology and Mineral Resources
Ministry of Forestry
State Physical Culture and Sports Commission
State Commission for Science, Technology and Industry
State Commission for Restructuring Economy

NEW MINISTRY-LEVEL BODIES
State Commission of Science, Technology and Industry for National Defence
Ministry of Information Industry
Ministry of Labour and Social Security
Ministry of Land Resources

MINISTRIES WITH CHANGED NAMES
State Planning Commission will be renamed State Development and Planning Commission
State Science and Technology Commission will be renamed Ministry of Science and Technology
State Education Commission will be renamed Ministry of Education

MINISTRIES, COMMISSIONS AND OTHERS THAT REMAIN UNCHANGED
Ministry of Foreign Affairs
Ministry of National Defence
State Economic and Trade Commission
State Nationalities Affairs Commission
Ministry of Public Security
Ministry of State Security
Ministry of Supervision
Ministry of Civil Affairs
Ministry of Justice
Ministry of Finance
Ministry of Personnel
Ministry of Construction
Ministry of Railways
Ministry of Communications
Ministry of Water Resources
Ministry of Agriculture
Ministry of Foreign Trade and Economic Cooperation
Ministry of Culture
Ministry of Public Health
State Family Planning Commission
People's Bank of China
Auditing Administration

Source. Reuters

Box 4.6: Intergovernmental Macroeconomic Coordination in Germany and Australia

In Germany, the budget is planned within the framework of a rolling five-year financial plan. These plans are prepared both by the federal government and the Laender (states). The *Financial Planning Council* then ensures that these plans are coordinated and that they are consistent with the aggregate fiscal target. The Council is chaired by the Federal Minister of Finance, with finance ministers from each of the Laender and representatives of municipalities as members. The Committee on Public Borrowing, which has a similar composition, and coordinates public borrowing and ensures that capital market demands are not destabilizing, complements the work of the Council. The Council decides on the overall level of borrowing, whereas the Committee decides on phasing of borrowing. The results of the deliberations are a Federal Financial Plan comprising of a set of compatible financial plans for lower levels of government. Based on this financial plan, budgets are prepared. Supplementary allocations are rare at all levels.

In Australia, before the Premier's Council decides on the overall level of transfers to the States, the Treasury prepares a memorandum for the Cabinet that outlines fiscal developments and prospects in the state and local sector. These are prepared in the context of the forward estimates of outlays for general-purpose assistance and the Commonwealth's broader objectives for public sector spending and borrowing.

Source: Barry Potter: Budgetary and Financial Management, in: Teresa Ter-Minassian, *Fiscal Federalism in Theory and Practice*, IMF, 1997.

- Budget proposals could be made to compete with existing policies by requiring agencies that propose additional expenditures to propose savings options as well. In the UK this is common practice, and Australia has a similar system, in which the Cabinet can choose to accept the new policy proposals, or to only accept the savings proposals of the ministry;
- Government could consider introducing explicit time limits on funding decisions. This so-called "sunset legislation" has been used in Japan and other countries, and has the advantage that policies have to be renewed by an explicit policy decision, at which time the effects of it can be evaluated;
- Agencies could be required to deliver an "efficiency dividend" for certain categories of expenditures, for instance running costs. Over time, with a change in personnel allocation policies, personnel costs should be included in such a system. (see Annex 8: The Running cost system in Australia);
- Even without reductions in overall numbers, governments at various levels could focus on increasing mobility of personnel among functions and agencies, thereby avoiding the costly redundancies that perpetuate the incremental budgeting. Within existing overall quotas, this would, among others, require simpler procedures for changing personnel files among departments, and more retraining within the administration.
- Mandatory spending increases in laws should be avoided. Such increases may thwart efforts to bring expenditures under control, and reduce the deficit. Once a MYEF is in place, such proposals can be scrutinized like any spending proposal, but until then, MOF should have a say in any of such proposals made. Beyond explicit consideration in the budget process, MOF would have to carefully monitor mandatory spending and entitlements in the budget. If the share of such expenditures becomes too large, the budget loses much of its flexibility, thereby severely restricting its use as a macroeconomic policy tool.
- *Minimize in-year adjustment.* To maintain the integrity of the policy choices made at budget time, in-year adjustments should become exceptions rather than the rule. Better revenue projections would help in allocating a larger proportion of resources at budget time.
- Such projections would also take away the incentive for ministries to continue to submit budget proposals during the budget

year: once the annual budget allocates all resources, there is no use in applying for more. In-year budget adjustments could still take place in exceptional circumstances, for instance when revenues are unexpectedly high, or when expenditures need to be cut to avoid inflation. In such cases, in-year adjustments should follow the rules of the Budget Law. The Budget Law prescribes that in-year adjustments should broadly follow the same process as the budget itself, except for NPC approval. If this process is followed, competition among proposals is assured, and dilution of policy priorities is avoided.

- *Realigning the budget year.* Finally, the budget year could be brought in line with the budget preparation calendar to increase predictability of funding for spending agencies and localities. Australia, after approving the budget well into the budget year for decades, four years ago moved the Parliamentary budget deliberations, so that the budget could be approved before the start of the budget year. China should consider whether it wants to move the budget year, or whether it wants to move NPC deliberations. Since the NPC plenary session has traditionally been held in spring, it seems unlikely that these will be moved. This leaves moving the budget year to, say, April 1-March 31. The disadvantage of moving the budget year is that it no longer coincides with the calendar year, which then requires separate macroeconomic projections for the budget year. However, many countries, including Japan, the United Kingdom, the United States and Australia have budget years that differ from the calendar year (Table 4.2).

Table 4.2: Current and Reformed Budget Process

Current budget process			*Tentative new budget process after reforms*	
			• *April (year-1)*	*Discussion of strategic priorities in State Council. Results disseminated to ministries, agencies and provinces*
			• *May*	*Discussion of strategic priorities and tentative budgetary implications with provinces*
			• *June*	*Central government and local governments update multi-year estimates. Fiscal outlook document produced by MOF. State Council determines overall spending limit for next three years*
			• *July*	*Evaluation reports of ministries tabled. Main savings options identified*
			• *August*	*Expenditure Review Committees meets, sets sectoral and ministerial expenditure limits for next three years.*
			• *September*	*Sectoral expenditure review committees meet, determine main savings, main new policy initiatives*
			• *November*	*Mid-year review of the budget. Multi-year expenditure estimates updated. Fiscal Outlook Document updated. Expenditure Review Committee determines key policy and spending changes.*
•	October-November	State Council orders drafting of the budget and sets out broad guidance for the draft	• *November*	*Key policy and spending changes discussed with provinces. Prospective grants identified; draft provincial budgets discussed*
•	October-December	Spending Units, Ministries, and local governments compile their draft budgets, and submit to the sectoral departments in MOF (In localities, some proposals do not come in until February of the budget year).		
•	November	MOF consults with Ministries and local governments on next year's budget		
•	November - December	National Finance Conference; MOF drafts central budget, and compiles State budget		
•	January	Fiscal Year Starts	• *January*	*Multi-year estimates for line ministries and sectors finalized. State Council decides on next year's budget proposal. Submits proposal to Standing Committee of the NPC*
•	January	MOF submits draft Central Budget and State budget to the State Council. Discussion in the State Council on outstanding issues and major projects.		
•	January-March	Audit of Spending units' accounts by the NAO.	• *February*	*Deliberations of the Standing Committee*
•	February	Presentation of Draft Budget to the Standing Committee of Finance and Economics of the NPC		
•	March	Presentation of the Central and State Budget and the preliminary Final Accounts by the Finance Minister to the NPC	• *March*	*Main policy changes, budget, and draft final accounts presented to NPC, and published. Sectoral and Line Ministry budgets approved.*
			• *March*	*Provincial Budgets approved*
•	March-May	MOF passes on the approved budgets to the spending ministries. Spending ministries pass on the approved budgets to the spending units	• *April*	*Budget Year starts*
•	January-April	NAO audits the central budget, reports to State Council	• *April-June*	*Audit Office audits financial statements of budget units and central budget. Reports to NPC, publishes reports*
•	June-July	Presentation of Final Accounts by the Finance Minister to the Standing Committee of the NPC		

CHAPTER 5
IMPROVING INCENTIVES FOR PUBLIC SECTOR PERFORMANCE

China's decentralized government structure could be a major strength in achieving public sector performance. Higher performance requires clear assignment of functions, more autonomy in policy implementation and resource use, a shift from compliance control to accountability for results, and information systems that monitors performance and enforce budget constraints

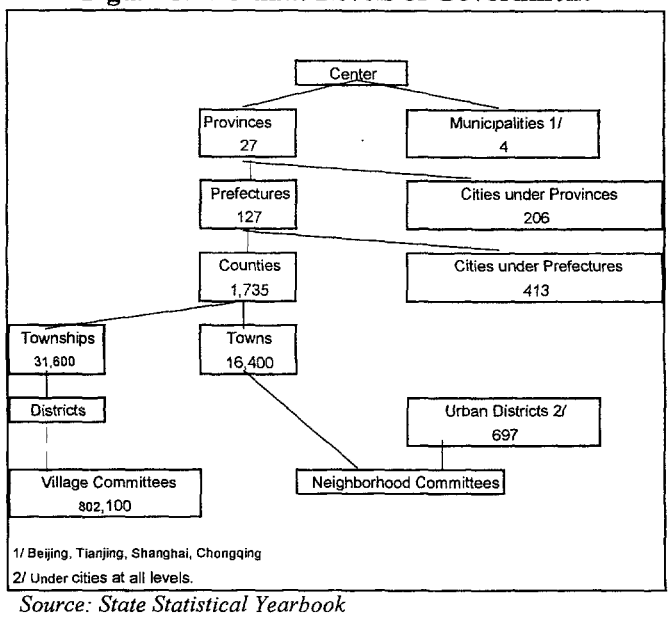
China's Decentralized Government

China's government is highly decentralized by region and function. It has 5 levels of government (Figure 5.1), with a total of some 50,000 entities. A growing number of government employees work at the local level (Figure 5.2).[1] Subnational governments spend over 70 percent of budgetary resources, of which about half is financed by central grants.

Functionally, China's central government has 40 ministries and commissions directly under the State Council, supplemented by 43 bureaus, institutions and administrations. Below these entities, about two thousand NPOs deliver most of central government services. Local line bureaus mirror much of the central structure, and an astounding total of over 1 million NPOs delivers services and employs much of the government workers. Education accounts for almost half of employment, followed by health care and natural resource management. NPOs are accountable to line ministries/bureaus and rely on a mix of budgetary support and EBFs.[2]

The decentralized nature of China's government could be a major strength. Service delivery close to the final user can better take their preferences into account, exploit local differences in costs and tastes, and stimulate innovations that further the Government's policy objectives. However, China's public sector managers do not have the autonomy, or the accountability, to exploit this structure. Many NPOs operate much like Government departments, and are subject to the government's budget procedures and personnel regulations, leaving little initiative to the managers. The lack of clear goals and inadequate reporting and accounting results in weak accountability, for results, nor are the rewards for civil servants linked to achieving these results. And insufficient competition from the non-state sector leaves much scope for improving the efficiency of service delivery.

Figure 5.1: China: Levels of Government



Source: State Statistical Yearbook

Functions are Unclear

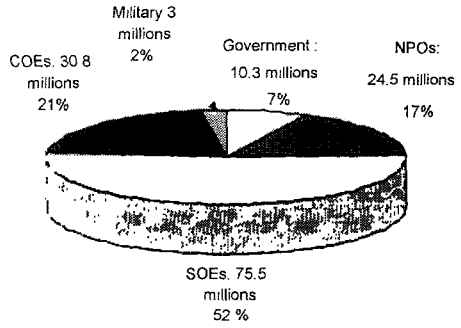
China's incomplete transition from a planned to a market economy has created a mix of commercial and government functions at agency levels. Because the division of responsibilities

[1] Except for 1994, when the national tax administration was established.

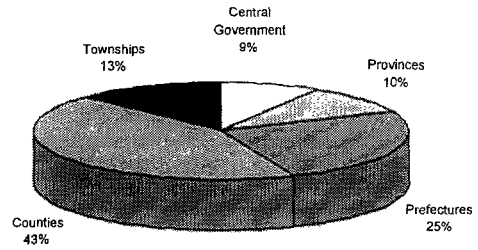
[2] According to the ministry of personnel, 60 percent of NPO personnel are fully financed from the budget, 23 percent partially, and 17 percent relies fully on EBFs.

Figure 5.2 :The Bulk of Public Sector Personnel is in NPOs at the Local Level

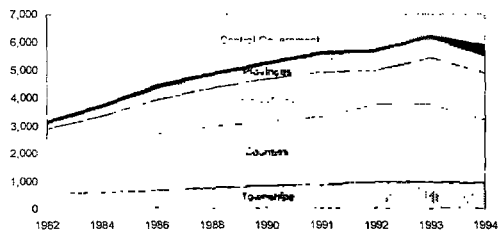
Public Sector Employment, 1994



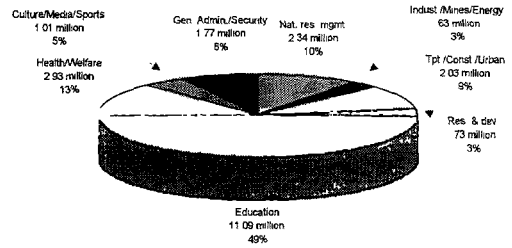
Government Cadres by Level of Government, 1994



Government Cadres 1982-94



Distribution of Personnel in NPOs, 1990



Note: Government Cadres are the equivalent of civil servants

Source: Ministry of Personnel

inheritance from the Maoist period–there is overlap and waste.

Mix of Government and Non-Government. China's NPOs are a very mixed bunch. Some, such as schools, hospitals, and research institutes have a clear role in the delivery of public goods, and are mainly funded by the budget. Others, such as seed management bureaus, veterinarian's services, and grain bureaus run commercial operations. The drive for commercialization since the mid-1980s has increased cost recovery for many government services–witness the exploding EBFs. At the same time, it led NPOs, and even ministries to enter in purely commercial services. School-run enterprises are common–and even stimulated by tax credits; the State Administration for Taxation runs commercial tax advisory services and a hotel; and the MOF runs a Trust and Investment Corporation.

These commercial ventures may generate conflicts of interest, but more importantly, they divert management attention and resources from the main purpose of the organization. This leads to inefficient delivery of the public goods the agencies are meant to produce. They also give government agencies the incentive to divert public funds in commercial ventures, as these generate the revenues that pays some of the salaries and most of the perks for the civil servants.

Concerning government functions, NPOs show little understanding how their activities fit in with Government priorities.[3] Their budgets are of little use as a guide, because these predominantly contain financial data, not goals and purpose of expenditures. Business planning and strategy formulation does not seem to take place in the NPOs, but is left to the supervising ministry,

[3] Source: Mission interviews

which seems to have a pervasive influence in the day-to-day operations of the NPO[4]

Unclear expenditure assignments. Unclear expenditure assignments remain a major weakness in China's intergovernmental fiscal relations. On paper, China's intergovernmental division of responsibilities is roughly in line with that dictated by public finance theory and reflected in international best practices (see Annex 10). In practice, several levels of government are involved in the same or similar activity. Much of the overlap results from the Maoist policy of self-sufficiency of each locality. Each province and even each municipality was supposed to be more or less self-sufficient.

Unfunded mandates. Central government regularly decides on policies that affect spending at the lower levels, but do not provide the financial means for the policy. Recent examples of these unfunded mandates include: the nine-year compulsory education; the grain pricing and procurement policy, the 1993 civil service wage reform; and the decision to create pension pooling for SOE workers at the municipal level. The grain policy alone cost the government of Jilin Province more than Y2 billion in trading losses in 1996, or one-quarter of the provincial budgetary revenues. The policy, which guarantees farmers a procurement price, caused the losses when a bumper harvest caused market prices to fall.

Local governments claim that "the central government throws dinner parties but leaves local governments to pay the bills." Unfunded mandates explain much of the disparities in service standards among regions: whereas richer regions can easily finance good health care and education from their own means, poorer provinces do no have sufficient funding to meet the central standards, nor do they obtain much in earmarked grants to do so.

Autonomy of Managers

Expenditure discretion limited, and misused. The budget law (Art. 56) and its implementing regulations (Art. 62) allow spending units to transfer among budget items only after approval by MOF (or finance bureaus at local level). The regulations do not specify an amount under which the budget unit itself could reallocate, nor does it specify the conditions under which such approval is given. In practice, budget units often do not seek approval for virement, and the Finance Minister's repeated remarks on funds diversion and abuse (see Chapter 1) indicate that reallocation is often not in line with the Government's goals.

Carryover does not pay. Art. 23 of the implementation regulations of the budget law allow for carryover of "special purpose" items. Apparently, operating costs are excluded from this carryover rule. The article prescribes that a surplus should be allocated to the budgetary reserve fund and the necessary expenditures in the following year. Thus, savings budget units have little incentives to save on their expenditures, as they will lose their budget allocation to the budgetary reserves, which are still well below the aspired level of 5 percent of expenditures.

Personnel management is inflexible. Line ministries and agencies have limited autonomy over personnel allocation. The State Committee for Public Service Structure under the State Council, assisted by the Ministry of Personnel determines how many people a ministry or an agency can employ. It also sets overall limits on local levels of government, which are further specified by local authorities. The personnel quota normally acts as an upper limit, because political pressures force government agencies and units to serve as employer of last resort. Line managers also have little incentives to save on personnel, as this is separately budgeted for. If they would save positions, they would simply lose budgetary allocation.

[4] This impression is based on mission interviews with NPOs and their supervising ministries.

Expenditure Monitoring and Control

Expenditure monitoring is perhaps the weakest link in China's budget process. Much effort is spent on ex-ante control, but actual expenditures are not monitored by the treasury system. Insufficient monitoring risks abuse of funds, and undermine accountability of managers.

Treasury does not monitor expenditures. China's treasury management system, adapted from the Soviets in the 1950s, does not monitor expenditures directly. The system records the transfer of funds from the central treasury account to ministry level bank accounts in commercial banks. From there, the money is transferred to bank accounts of the spending unit, from which spending takes place. Reconciliation with bank account statements only takes place with the final accounts, after the budget year has closed.

In contrast with expenditures, the spending unit's requests for funds that spending units submit undergoes elaborate scrutiny: at spending ministry level; at the sectoral department in MOF; at the accounting division of the budget department in MOF; and at the treasury department of PBC. However, the scrutiny rarely ever leads to changes in the request for funds, and the decisive factor for release of funds from MOF is whether sufficient funds are available.

The treasury management system results in a large float of government money in the banking system. Moreover it leads to much delays in disbursement of funds to spending agencies, and possibly to payment arrears. At the same time, the system provides little effective expenditure control and monitoring by MOF, and therefore little accountability for line ministries and agencies.

No reporting on results. China has an elaborate reporting system for the treasury and spending units. Spending units report monthly and annually to supervising ministries, which compile reports for MOF. MOF, however, only substantially evaluates the annual reports. The central treasury reports daily, monthly, and annually to MOF, both on its own operation and on the operations of treasuries at provincial levels. Daily and monthly reports consist of aggregate numbers on revenues transferred to the treasury account, transfers made from the account, and the treasury account balance.

Accounting system and budget classification. China's accounting system is cash based, and as such cannot record cost. Assets are recorded, but this is done separate from the budgetary accounting system. The spending units record transactions in a great amount of detail, but most of this is lost in aggregation at the ministry level. Spending units report to their supervising ministry or bureau, which consolidates the accounts of all subordinate-spending units. The aggregate reports sent to the MOF contain little operational information.

The accounting classification is a mix of functional and economic classification. Some items–such as subsidies to SOEs–are recorded as a subtraction from revenues rather than expenditures. Interest payments are recorded below the line, thereby causing an underestimate of the budget deficit. The cash basis of the accounting system precludes adequate recording of arrears. Arrears are regularly reported in grain procurement and teacher's pay, but perhaps the largest arrears accrue in the value-added tax refund. At the end of 1995, the amount of arrears was reported to be over Y80 billion. This implies that the budget deficit on an accrual basis was almost 1.5 percentage point of GDP larger than the cash-based deficit of 1.7 percent.[5]

Final accounts have financial information only. China's final accounts provide only limited insights in the State's finances. They include detailed statements on revenues and expenditures, but do not report on assets, liabilities, contingent liabilities, guarantees, flow of funds, and other reports that are usually included in OECD countries' fiscal reports. No systematic reporting on outputs or outcomes of expenditures takes place.

[5] See: Garamfalvi et al *China: Government Budgeting and Treasury Management: Issues and Proposals* for a detailed review of China's budget classification.

Audit

External audit focuses on compliance. Audit in China is mainly limited to compliance audit. The audit law requires the Audit Authorities to inspect whether money is well spent, but the limited performance reporting, and the lack of relevant skills in the Audit Authorities prevents widespread value-for-money audits. However, in 1996, for the first time, the Audit Authorities reported directly to the NPC on the central final accounts of 1995.[6] Before, reports were made to MOF and the State Council. Among the auditors' findings was that budgetary money was used to speculate on the stock market–a direct consequence of weak treasury management. The Audit Authorities are expanding their capacity for value-for-money audits, but are still severely limited by the information included in budget requests and fiscal reports.

Internal audit is extensive. Internal audit in China is extensive. The supervision department of MOF checks line ministry and agency compliance with financial and tax regulations. The Ministry of Supervision investigates administrative misconduct that may result in criminal cases, and the annual Fiscal and Tax discipline examination campaign does both. The campaign is a phenomenon specific to China: during several weeks each year personnel are switched from their own unit to another unit to conduct a review of the books. The focus of each of these internal audits is again compliance with regulations, not on performance or value for money. Moreover, there seems to be considerable overlap in the various internal audits, and some SOEs and State Banks that are also subject to the audits complain about the time involved in them.

Incentives for civil servants

Civil service pay not linked to performance. MOF and the ministry of Personnel centrally determine pay. Despite several rounds of wage reforms, civil service pay lags behind that of SOE employees, and much more so behind that of the emerging private sector. Civil service pay is mainly based on longevity and grade, and shows little relation with performance. Although there are bonuses, these are mostly seen as part of the normal wage, not as rewards for good performance.

The civil service wage structure is becoming more compressed. In 1985, the highest-ranking official earned about 7 times more than the lowest ranking, down from over 10 in 1955. By 1993, this was less than five times (Table 5.1). Wage compression was necessary to keep the overall wage bill low in light of an inflation in ranks. In 1982, 82 percent of all civil servants were normal staff; in 1994, this was only 60 percent. The decline is fully explained by the rapid increase in the number of section chiefs.

Table 5.1: China: Civil Service Wage Structure 1985 and 1993
(mid-point salary, Yuan per month)

Ranks	*1985*	*1993*	*percentage change*
Premier	453	1115	146
Vice Premier	343	984	187
Minister	282	881	212
Vice Minister	236	769	226
Director General	189	668	253
Deputy Director	165	581	252
Division Chief	146	489	236
Deputy Division Chief	127	422	232
Section Chief	110	372	240
Deputy Section Chief	94	330	252
Section Member	80	302	276
Clerk	67	264	294

Source: Ministry of Personnel

A developing civil service system. China is rapidly developing a civil servant system. The 1993 Provisional Regulations on Civil Service lay the basis for such a system. The regulations aim to: establish competitive examinations at entry; allow dismissal of incompetent workers; and to systematize training and career perspective for civil servants. A job rotation system for director level civil servants has been introduced, and a civil service training school has been founded. The civil service system has been introduced down to the municipal level.

[6] See: *Renmin Ribao* (People's Daily), July 4, 1996.

Competition

China makes little use of the nonstate sector for public goods provisioning. NPOs and SOEs deliver the bulk of services, and little is contracted out. Although some private financing of energy and transport investment has taken place in prosperous coastal regions, this is still met with much skepticism of central officials. Recently, China concluded its first Build-Operate-Transfer scheme for energy with private foreign capital as the main financiers. However, municipal services such as water supply, garbage collection, and street cleaning; and social services such as health and education are firmly in the hands of SOEs and NPOs.

Procurement rules are weak. China's underdeveloped government procurement system is an impediment against more non-state involvement in public goods provision. Government procurement often involves simply shopping for the item needed. Competitive bids are usually limited to SOEs. China's informal arrangements give rise to waste in budget implementation, and could be a major cause for corruption. Despite recent improvements, China still ranks low in *Transparency International*'s corruption listing (Table 5.2). Government procurement rules have become a bone of contention in China's WTO negotiations. In recognition of these problems, China is currently preparing a government procurement law.[7]

Citizen's charters work. In some localities, China has its own form of Citizen's Charters, named "Social Service Commitment System."[8] according to the system, government organizations and public utilities publicly state their service commitments. Apparently, complaints about public services went down dramatically after the introduction of the system. Many cities have their "mayor's hotline" on which citizens can express their complaints on public services.

Table 5.2: A Perception of Corruption

Rank	Country	Score 1996 (max. 100)
1	Denmark	9.94
2	Finland	9.48
...	...	...
40	Philippines	3.05
41	China	2.88
42	Argentina	2.81
52	Nigeria	1.76

Source: Transparency International

Recent Reforms

China has major ongoing initiatives to improve incentives for the public sector. Since 1990, the administrative reforms have encouraged separation of commercial activities from government through corporatization. Some ministries–such as those for Light Industry and for Textiles–have become industry associations, although they continue to perform some government regulatory functions. The number of civil servants at all government levels fell by some 10 percent since 1994. The next wave of reforms targets a reduction of 10 percent in NPO personnel. Following the Civil Service Regulations, China has introduced competitive entry exams, and a pilot wage comparison between civil servants and SOE workers was done, in preparation of further wage reforms. MOF and PBC have also started experimenting with better treasury management. For now, these experiments still focus on the revenue side of the budget, but better expenditure monitoring is on the agenda. Finally 12 provinces, including Heilongjian, experiment with alternative ways of personnel management. In the experiment, each level of government is responsible for managing the administrative expenditures of the government one level below. The principle of the experiment is to "manage the next level, controlling indicators, fixed amount management, awarding with savings, and penalizing when overspent." Since the start of the new management method, Heilongjian apparently has had the lowest increase in administrative expenditures of all provinces.

[7] See South China Morning Post, May 5, 1997.

[8] See *China Daily*, October 26, 1996.

Enhancing Incentives for Public Sector Performance

To improve results of China's public sector, the Government should enhance the incentives for performance. Building on ongoing initiatives, Government should give priority to further differentiating between government and non-government, and between the functions of the various levels of government. MOF should focus on accountability for results by improving treasury management, accounting, and reporting. Pay linked to performance, and a sound civil service system, should provide government workers the incentive to perform.

Clarify Functions

Review the Role of NPOs. China could use the review of NPOs to further clarify their functions, and provide a clearer separation of Government and non-government. As chapter 3 argued, much scope exists for turning NPOs into enterprises, and dissolving remaining NPOs from the budgetary framework. In the future, *non-government* NPOs are likely to provide a growing share of government services. It is necessary for government to provide the appropriate framework, and, if required, to provide subsidies for those activities that remain within its realm.

From Budgeting to Performance Specification. As a start, the budget process can be used to better specify the roles and responsibilities of NPOs. Including output and performance indicators in the unit budgets will clarify the unit's responsibilities. Over time, Government could consider further steps in specifying role and function of budgetary organizations. Some countries require each unit to regularly submit unit strategies that specify the aim of the unit, its main policies, and the key performance indicators by which achievements can be measured. Often, budgets are accompanied by detailed business plans that cover the activities to be undertaken with the budget. For service delivery units, a more formal system of output budgeting could over time be considered to replace the current system, but only if the accounting and reporting systems are far enough advanced to hold units responsible for their performance.

Improve Information and Monitoring

Better treasury management. Key to improved accountability of the budget is a sound treasury management and accounting system. Such a system needs to monitor the proper use of government resources and optimize cash management. It should also provide crucial information for policy decisions, and for keeping managers accountable.

In the longer run, China could adopt the Single Treasury Account/General Ledger system that exists in all OECD countries, and on which the IMF provides Government with advice. In fact, 2,000 central spending units (Government Ministries and their subordinated NPOs) is a manageable number for a single treasury account supported by transit accounts and integrated regional treasury accounts. The development of such a system takes time, but with only minor adjustments to the accounting system, immediate improvements could be made by:

- Merging the treasury account and the special fiscal account for EBFs managed by MOF.
- Merging the budgetary and the extra-budgetary spending accounts of spending units
- Skipping one or more steps in the elaborate procedure for requesting funds, as the only binding criteria seem to be availability of funds in the treasury. All OECD countries, except France and Germany, have abolished detailed expenditure control in implementation, and only focus on aggregate spending limits. The budget unit itself has the responsibility for spending according to the budget.

Reporting on Results. China's fiscal reporting should be expanded to include information on the results of expenditures. In line with more detailed performance specification in budgets, regular reports on results, and how results compare with what was expected in the budget.

Accounting for performance. China needs to consider moving to a more useful budget classification that includes an economic and an organizational classification and improves the existing functional classification. A revised accounting system should also be able to deliver cost information for the Government's major programs, policies, and products.

Over time, China should consider moving to an accrual-based accounting for budget units. This worldwide trend in public sector accounting promises to be highly conducive to performance orientation. Several OECD countries have moved to accrual accounting and budgeting, and many have introduced accrual elements in their accounting system for budget units. However, only New Zealand has introduced accrual budgeting and reporting for aggregate budget reports. While building such as system will take time, immediate improvements could be made by requiring spending units to report more of their grassroots information, including the information that exists on economic categories, and to redesign reporting formats and procedures such that information does not get lost in aggregation. China's good records on assets that budget units maintain would facilitate a possible move to accrual accounting.

Value for Money Audit. The nature of both internal and external audits needs change. In line with improving treasury management, much of the current *internal audit* could be phased out, and replaced by MOF's off-site expenditure monitoring. In contrast, external audits need considerable strengthening, and should focus more on results than on compliance. The auditors of the National Audit Office need considerable training in this area.

Fiscal Information System. The key to a well functioning fiscal system that provides MOF with sufficient policy information, and budget units with the incentives to comply, is a versatile fiscal information system. This system should build on an improved treasury and accounting system, should link the approved budget with budget implementation data, disbursement with procurement information, and the annual budget with the multi-year budget. MOF is only at the start of such a system. Automation within the ministry is limited, and reporting systems from spending ministries, units, and other levels of government have great scope for improvement. Annex 9 provides a generic outline of such a system.

Give More Autonomy to Managers

Clearer functions, better monitoring and auditing allows for more autonomy of budget units. Without more autonomy, compliance with the budget may improve, but efficiency gains will only be limited. Autonomy can gradually increase by allowing more and more flexibility in resource transfers within the operating budgets of budgetary units.

Establish detailed rules on resource transfers and savings. MOF should clarify the rules for virement and carryover. It could consider setting limit amounts under which a budget unit could reallocate without permission from MOF. MOF could also reconsider the rule that allocates savings firsts to the budgetary reserves, because this is a disincentive for units to save. MOF could also promote efficiency in budget implementation by making explicit arrangements for dividing efficiency gains between the spending unit and the general budget. Currently, a spending unit has strong incentives to spend its full allocation in fear of losing the funding from its base number. The arrangements used in the Australian running cost system could serve as a useful example (Annex 8).

Allow more flexible staffing. Since personnel costs are a large chunk of the running costs of budgetary units, the scope for savings would be greatly increased, if managers were granted more autonomy in staffing. If managers actually have the incentive to save resources, they will rapidly revise their current tendency to maximize personnel. More autonomy over personnel at the agency level allows for more efficient staff reductions than the current centrally-mandated reductions.

Increase certainty of funding. Building on the proposed MTEF, China could increase the certainty of funding. Once the MTEF is in place, and all ongoing expenditures have been evaluated on their continued usefulness, the budget allocations could be projected for several years. Within the MTEF, these funding levels would normally only change if policies change. Increased certainty of funding increases the planning horizon of a budget unit, which would benefit its operations, and would enhance managers' incentives to innovate and save costs, if at least part of the savings can be used by his unit.

Increase Competition

More competition in public goods provisioning puts pressures on budget units to save resources. Increased competition can come from outside the public sector, but could also be generated within the public sector, by increasing cost recovery and publicity on performance.

Involve the non-state sector. Government should consider actively encouraging the emergence of a nonstate service delivery that would compete for clients with NPOs. This would require the elimination of general price subsidies for public services, the monetization of service delivery in the public sector and the targeting of poor beneficiaries who cannot pay market prices and fees. A major benefit of private sector development in service delivery would be the creation of an alternate market for surplus NPO staff.

Strengthen cost recovery in NPOs. Increasing cost recovery for public services can be a powerful tool for efficiency. This would include reducing the list of NPOs whose staff is paid by the budget and accelerating the phasing out of grants. Combined with competition by the private sector, NPOs would be impelled to improve services while reducing costs. NPOs that can be fully financed from user charges could be commercialized, and divested from Government.

Improve government procurement. China's plans to improve public procurement are a priority. China could improve procurement by requiring a procurement plan for each project, to be evaluated together with a funding proposal. For large procurements, standardized procedures for competitive bidding should be adopted. Smaller non-standard procurements could be made subject to local shopping, requiring the purchaser to obtain at least several price quotations for the item to be purchased. China could consider a "Catalogue" approach for small standard procurements (Box 5.1). This would require a central unit to set up competitive bidding for items to be included in a catalogue of standard items such as pens and paper. Spending units could then simply buy from the catalogue.

Actively use competitive elements in public services. China could promote the use of competition substitutes in services not easily commercialized. Measures Government could consider include:

- *Published service standards.* Building on the local initiatives with service standards, Government could require those standards for each spending unit. Government could use standards not only for services to the public, but also for internal processes. Publishing the standards widely, and monitoring a unit's performance will force unit personnel to meet those standards.
- *Benchmarking.* China's decentralized government lends itself well to the use of benchmarking. Comparing the performance of similar institutions in various regions, and publishing the results of these comparisons, can be a powerful tool for enhancing performance.
- *User funding.* Shifting funding from provider to user could increase competition and efficiency within the public sector. For example, funds for training could be allocated to the operational departments rather than to the training center directly. Over time, this philosophy could be applied to policy funding as well, e.g., by providing vouchers for education instead of funding schools.

Motivate Civil Servants

China needs to develop a pay system in the public administration that will provide rewards for strong performers. The job evaluation and grading that the Ministry of Personnel is undertaking is a first priority for this. Job grading should link civil service jobs with equivalent ones in the market economy, where pay reflects productivity. Increasingly, the proper benchmark will not be the State enterprises, but the non-state sector. However, providing similar pay for similar jobs is not enough: it is *performance* that deserves rewards. For this, the civil service needs a system to evaluate performance on a regular basis, and to link wage increases and bonuses to performance. China could over time consider delinking core civil service wages from NPO wages.

Revamp Intergovernmental Fiscal Relations

Better incentives for budgetary units may increase public sector performance at each level of government. But to eliminate the duplication of functions among levels of government, and the glaring disparities among provinces, intergovernmental fiscal relations need revamping. A full treatment goes beyond the scope of this report, but China could consider further clarifying expenditure assignments, accelerate the introduction of an equalizing grants scheme, and make selective use of earmarked grants to promote national goals.

Clarify Expenditure Assignments. Reducing overlap among levels of government remains a key area for further efficiency gains. Annex 10 provides some general principles and international evidence on expenditure

Box 5.1: US and World Bank Procurement Rules

US Federal Government Procurement

Public procurement by the US Federal Government is done by several agencies. The General Service Administration (GSA) does procurement of some items, mostly large-volume purchases, mainly for domestic purchases. The Federal Supply Service (FSS) buys, stores, and distributes a variety of goods for GSA. Some other agencies, including the Department of Defense also has procurement authority.

GSA publishes a Government Supply Catalogue. For individual or groups of items in the Catalogue, GSA organizes competitive bids. The winner gets listed in the Catalogue, which lists complete item descriptions, prices, the name of the winning bidder, and the period of bid validity. Most purchases up to an amount of US$25,000 are done through the Catalogue.

Construction, Goods, and Commodities. According to the Federal Acquisition Regulations, all US federal government contracts costing more than US$25,000 must be awarded by competitive bids under the terms of the Competition and Contracting Act (CICA) of 1994. The Act requires full and open competition by sealed bid. All upcoming bids are advertised in the Commerce Business daily, a publication of the US Commerce Department. There are exceptions to competitive bidding, as listed in the CICA, including criteria when "sole sourcing" is allowed. Each exception to competitive contracting must be justified in writing.

Consultants. Procurement of consultants follows a procedure by which negotiations take place with bidders. A request for proposal is published in the Commerce Business Daily, and proposals are reviewed on the basis of technical and financial proposals announced in advance. Those firms that are in a "competitive range" are invited for negotiations.

World Bank Procurement Rules

The World Bank has a set of rules for procurement similar to those of the US government for goods and services procured under its loans and credits. The competitive processes for goods are split into International and National Competitive Bidding (ICB and NCB). ICB is used for large procurement, where "large" is defined per country and per category of goods. Usually, the threshold is larger for construction.

The competitive bid can have a one stage or a two-stage process. The one stage is mostly used for straightforward procurements, and is similar to the US system. The two-stage bid allows for discussions with the suppliers that meet a certain minimum technical score on the criteria set in advanced. These bidders are invited for discussions on the technical proposals. The criteria for the technical proposal can be changed by the buyer during that stage, and the bidders can adjust their technical bid. The reason for this is that the buyer can benefit from the information in the technical bids, and can adjust its technical criteria accordingly. In the second stage, bidders submit a revised technical proposal, and a financial proposal.

A third technique under Bank procurement is international or national shopping. For smaller, fairly standardized goods, a buyer can obtain several price quotations, either internationally or nationally, and can award the contract to the lowest bidder.

A recent addition to Bank rules excludes suppliers who have been found to violate competitive practices in earlier procurements, e.g. by bribing officials from bidding.

assignment. No single right expenditure assignment exists, but the assignments should be clear to the participants in the budget process to avoid costly overlap. As a start for a more comprehensive review of assignments, Government could include a clearer division of functions, expenditures, and revenues in every new policy proposal and law.

Revise Intergovernmental Fiscal Relations. China will not overcome the regional disparities in service delivery without further revision of intergovernmental fiscal relations. The 1994 reforms insufficiently redistributed resources among provinces, and will continue to do so for a long time. Annex 11 suggests an intergovernmental grants system that will more quickly reduce horizontal disparities, by availing an increasing share of the tax return grants for equalization. Although China could choose different means to bring greater equalization, without it, the country will not improve service delivery in poorer provinces.

Earmarked grants. In addition to general equalization grants, China could rethink its system of earmarked grants. The current transfers are mainly used for SOE subsidies, but they could become a tool for furthering national goals, without imposing unfunded mandates on lower level governments. Since most of the service delivery takes place at subprovincial levels, central government could consider targeting these grants to municipal or even county levels. Although the effective design and monitoring of earmarked grants is no easy matter, the task will become less cumbersome with improved budgeting, treasury management and accounting systems.

Box 5.2: The Four Pillars of Successful Civil Service Systems

Working environment. The ability of economic technocrats to formulate and implement policies in keeping with politically formulated national goals depends on the extent to which they are effectively insulated from lobbying for special favors by politicians and interest groups. Various systems exist to insulate technocracies: Hong Kong, Japan and South Korea have evolved administrative and legislative systems which give primacy to the bureaucracy in proposing laws. In Japan, the bureaucracy is further protected from political pressure by the National Personnel Authority, an independent body that sets the bureaucracy's pay scales and promotion policies, administers civil service exams, and makes most appointments. Japan's Prime Minister names only his ministers and, except in a few cases, one of the two vice-ministers in each ministry. The NPA is responsible for all other appointments.

Merit-based recruitment and promotion. Highly qualified staff will be attracted to a civil service career if entry and promotion are directly related to their ability to compete. In successful civil service systems such as Japan and Korea, recruitment revolves around highly competitive entrance exams, administered by national personnel authorities. Success rates are low, which indicates the high standards expected by applicants. Promotions in Japan are based on a combination of seniority and a host of performance indicators that differ across ministries. Because law fixes the number of personnel in the bureaucracy, competition for promotions is intense. Furthermore, throughout the career of a civil servant, the lack of career progression points to inadequate performance and will be sanctioned by early dismissal.

Incentive-based compensation. In bureaucracies as in all other walks of life, you get what you pay for. Most successful bureaucracies have put into place incentive systems that are geared to make the civil service competitive with jobs offered in the private sector at most ranks. Obviously, senior civil servants may not receive compensation equivalent to Chief Executive Officers in the private sector, but at those levels in bureaucracies, other intangible incentives are present. Thus, monetary compensation is a very powerful incentive and the divergence between compensation in the civil service and the private sector, at all hierarchical levels, should not be excessive.

Predictability of career paths. A final requirement for a successful bureaucracy is a well-defined, competitive career path, with a substantial prize for those who make it to the top. Young entrants into the civil service will be willing to commit themselves to a civil service career if there are reasonable prospects that sustained high performance will allow them to enjoy relatively rapid promotions and to achieve a high rank in the administration. In Japan as in other East Asian civil service systems, retirement comes early, and the rewards to a successful bureaucrat are substantial, extending beyond the pay, perks and prestige to include golden parachutes.

The Changing Role of MOF

MOF can play a major role in the reforms proposed in Chapters 3-6 of this report. In many OECD countries, MOF has taken the lead in expenditure management reforms, by generating discussion on public sector performance, designing new budgeting procedures, reporting formats, accounting procedures and developing evaluation capacity. MOF could be this catalyst of change for China.

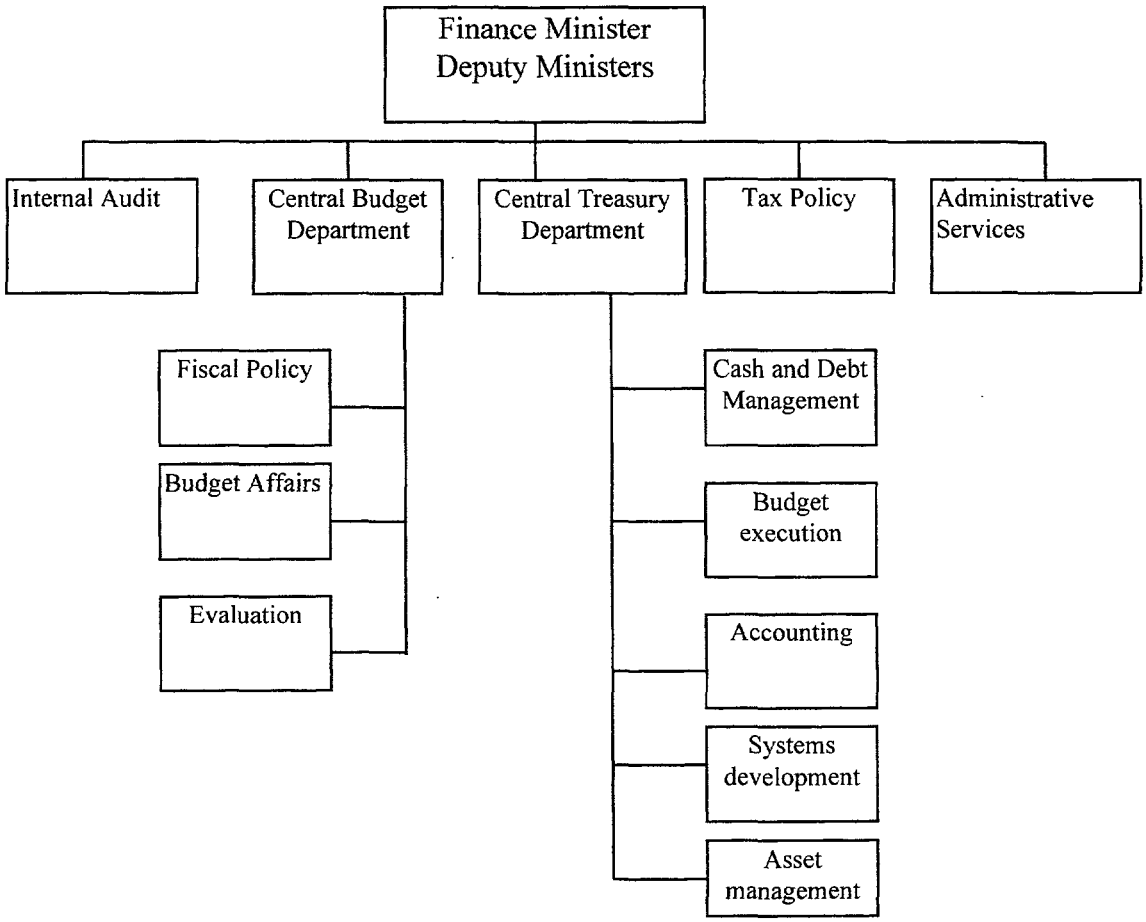
But what would MOF's role be in a reformed expenditure management system? Much depends on how the budget process evolves. If the budget becomes the Government's main tool for policy, MOF is likely to become more involved in the analysis and evaluation of policy. As a minimum, MOF would be involved in setting the standards for policy evaluation, and be in charge of determining the budgetary implications of new policies. Whether it will play a major role in setting the policy agenda depends to a large extent on the role of SPC, which currently determines much of this agenda. If the Government decides to move to a multi-year budgeting framework, MOF is the obvious candidate for managing the forward estimates, and determining the budgetary room available for new policy.

But improved links between strategic policy and the budget will greatly reduce MOF's role in detailed budget preparation. The expenditure review committee, or some high level political body, will set overall policies and sectoral expenditures within which the line ministries make their trade-off. In principle, MOF would no longer need to deal with detailed budget negotiations to cut expenditures within available means.

In budget implementation, MOF's role in expenditure monitoring will increase, once a proper treasury management system is in place. A good treasury system would do away with much of the on-sight internal audit of the Supervision Department, and replace this by off-site monitoring. However, with increasing autonomy of line ministries and agencies, expenditure monitoring will become more and more a control of aggregates, not a detailed scrutinizing of budget requests.

With the changing role of MOF, its organization will change as well. The current structure–with over 20 departments–can over time be greatly simplified. MOF could consider a departmental structure focused on its core processes, namely: budget preparation, budget implementation (treasury), internal audit, and tax policy (Figure 5.3). A separate department could then take care of all administrative services. In this suggested structure, the sectoral departments would be abolished. Their functions in budget preparation would be included in the central budget office, whereas their budget implementation function would become part of the treasury office. The central budget department would be in charge of the annual budget, the multi-year expenditure framework, and overall fiscal policy. The treasury department could assume much of the tasks in budget implementation, including cash management, debt management, and accounting.

Figure 5.3: Possible structure of MOF



ANNEX 1:
CHINA'S EXPENDITURE MANAGEMENT SYSTEM

Legal Framework

In March 1994, the NPC approved an organic Budget Law, which became effective January 1, 1995. The law replaced the State Council "Regulations on State Budget Management" of October 1991. The Budget Law specifies the budgets of the various levels of government; the roles and responsibilities of the agents in the budgetary process; the scope of the budget; the various steps in the budget process; and the legal responsibilities of the agencies involved in the budget process. The law delegates issue of detailed regulations to the State Council. Such regulations were issued on November 22, 1995 (State Council Decree No. 186). Further legal underpinnings of the budget process are: MOF regulations on "General Budgetary Accounting System of Fiscal Departments" and the "Budgetary Accounting System of Administrations and Institutions" effective January 1, 1989; and the Sate Council Circular No. 29 of July 16, 1996 "The Decisions on Strengthening the Management for Extra-budgetary Funds."

The Budget Law (Art. 47) states that each level of government with a budget institutes a treasury and that the central treasury is managed by the PBC. The State Council issued regulations on Treasury Management on July 27, 1985, replacing regulations of 1950. MOF and PBC issued detailed regulations on December 13, 1989. In practice, MOF is primarily responsible for drafting regulations concerning the Treasury.

Budget Scope

Chapter III of the Budget Law defines the scope of the budget. It defines four revenue sources of which tax revenues and revenues from State-owned assets are the most important. It further defines, in general terms, six expenditure categories, among which are economic construction and administrative expenditures.

China has five levels of budgets (central, provincial, municipal/prefectural, county, and town/township); each approved by their corresponding levels of People's Congresses. Not all towns and townships present a budget. Since effectiveness of the Budget Law, the local People's congresses approve the local budgets. They check whether the budget conforms to national laws and local regulations. The local budgets are submitted to MOF for the record and for compilation of the State budget. The budget speech of the Minister of Finance to the NPC still presents the consolidated State budget, but the NPC only approves the central budget.

The budget format is the "Dual Budget System" which divides revenue and expenditures in a recurrent and a construction budget. The recurrent budget contains investment expenditures in "nonproductive" sectors such as education and health, and the construction budget contains recurrent expenditures to support productive activities, such as geological prospecting. The budget expenditure classification is a mixture of economic classification (e.g. capital construction) and functional classification (e.g. education, science and Health). However, even the functional classification is a mix of functional and organizational classification, because the accounting system does not delineate separate functions of spending units clearly. Borrowing and repayment is accounted for "below the line" since 1997, but so are interest payments.

Extra-budgetary Funds

A substantial amount of government resources falls outside the scope of the budget. These "extra-budgetary funds" of government agencies and institutions consist of levies, fees and tax surcharges that accrue mainly to local governments. There are as many as 600 types of funds, not all approved by the relevant authorities, which amounted to Y380 billion in 1995. The EBFs originated in times of strict central budgetary planning as a means of providing some limited autonomy to government bureaus and spending units. By 1995, however, these funds had grown to over 5 percent of GNP, or almost a third of government resources. MOFs' Comprehensive Department compiles statistics on EBFs, and the State Council has issued various regulations on them, including Decision No. 29, which orders integration of 13 funds amounting to Y115 billion in the budget, and tightens controls over other EBFs (Annex 5).

The State Council circular abolished the off-budget nature of the "self-raised funds" which lower levels of government raised. This category, which was not registered in the fiscal reporting system, consisted mainly of levies on township and Village Enterprises at County and Township levels.

Quasi-Fiscal Resources

The banking system has provided financing for government expenditures outside the budget. "Policy loans" extended by the State banks, and in large part refinanced by the PBC, added an estimated 5-7 percent of GDP to the government resource envelope. Policy loans provided an interest rate subsidy to the recipient of 10-70 percent of standard interest rates. These subsidies were in principle to be covered by the Budget, but banks regularly report on arrears of the Budget. Since the establishment of the Policy Banks in 1994, policy lending through the commercial banking system has been reduced. The State Development Bank provides about Y100 billion per year in loans to the government's priority projects. Policy loans are directed according to the credit plan, which is drafted by the State Planning Commission (SPC) and implemented by the PBC. Beneficiaries of these loans are enterprises in sectors that implement public investment projects, or that make losses due to the social burdens and price limitations imposed on them by government. The bad debts in the banking system, a contingent liability for the budget, are estimated to amount to 20 percent of the banking loans, or almost 20 percent of GDP.

Budget Year

The budget year coincides with the calendar year, January 1-December 31. Since budget approval only takes place in March at the central level, the budget year is effectively reduced to nine months. According to the Budget Law, Article 43, until the budget for the current year is approved, expenditures not exceeding those of the previous year are allowed. In practice, this may mean that some local spending units do not have their budgets approved until May of the current fiscal year.

The Budget Process

Budget preparation. Formally, the State Council is responsible for drafting the budget, but the Minister of Finance is assigned responsibility for practical organization of the work and compilation of the draft budget. Budget preparation starts in October-November with the State Council's letter to central government ministries and provincial governments on the expected macroeconomic developments for the next fiscal year (see Table A1.1). The letter, drafted by MOF contains the expected revenue and expenditure developments. These figures are based on historical experience, the current year's budget implementation, and on SPC's letter on macroeconomic developments. The State Council letter does not provide expenditure limits, either overall, sectoral or organizational. The ninth Five-Year Plan, however, has as a goal to "basically eliminate" the budget deficit.

Table A1.1: Indicative Budget Calendar

October-November	State Council orders drafting of the budget and sets out broad guidance for the draft
October-December	Spending Units, Ministries, and local governments compile their draft budgets, and submit to the sectoral departments in MOF (in localities, some proposals do not come in until February of the budget year)
November	MOF consults with Ministries and local governments on the next year's budget
November-December	National Finance Conference; MOF drafts the Central budget and compiles the State budget
January	MOF submits the draft Central and State budget to the State Council. Discussion in the State Council on outstanding issues and major projects
January-March	Audit of Spending units' accounts by the National Audit Office
February	Presentation of the draft Budget to the Standing Committee of Finance and Economics of the NPC
March	Presentation of the Central and State Budget and the preliminary Final Accounts by the Finance Minister to the NPC
March-May	MOF passes on the approved budgets to the spending ministries. Spending ministries pass on the approved budgets to the spending units
January-April	National Audit Office audits the Central budget
June-July	Presentation of Final Accounts by the Finance Minister to the Standing Committee of the NPC

Source: MOF, Budget Law.

Spending units and line ministries prepare their budget proposals on the basis of: (1) laws and regulations; (2) the State Council's circular on the budget, which prescribes the budget to be prepared in line with (a) the growth rate of GDP, (b) forecasted revenues and (c) the social and economic development plan; (3) the quota and standard expenditures of every spending unit; and

(4) the results of the current year budget implementation. In practice, this has led to an incremental budgeting which took last year's expenditures as the base of the budget, with an increment related to the overall revenue increase (Base number method). Enterprises do not submit a budget but a financial plan, which may include budget support for the enterprise. The ministries review the proposals and consolidate them with the budgets for ministerial expenditures. The ministries submit the consolidated proposals to MOF, together with about 30 pages of motivation, summarizing the proposals of the spending units. The budget submission is summarized in several standard forms. The mission was handed a proposal that contained three forms. Spending for a Ministry is divided into main categories, each subdivided in: (1) personnel costs, (2) office expenditures and (3) special projects. Various expenditure norms for personnel and office costs exist, which are included in MOF's budget circulars.

The budget proposals take the EBFs of the spending units into account, but they are not budgeted for. The 13 EBFs that the State Council ordered integrated in the budget (including the Electricity Fund and the Railway Fund) are gradually integrated, although not all localities are yet complying with this regulation.

Apparently, a ministry can submit several budget proposals to MOF. The proposal for budgetary money to enterprises subordinated to the ministry is separated from that of the budget for Non-Profit Organizations under the ministries. The reason seems to be that separate sectoral departments in MOF are responsible for reviewing the drafts. For example, the Ministry of Agriculture submits two drafts to the Agriculture Department in MOF, one for the NPO division, and one for the Enterprise division.

Sectoral departments within MOF, in consultation with the Budget Department, review the proposals. The review focuses on additional spending over last year's expenditures. Usually, a spending ministry would end up with about 20-30 percent of the requested additional budget. The overdemand is used as a negotiation strategy: it shows the priority of the sector and positions certain proposals for the following year's negotiation process, because a proposal is usually accepted after it has been submitted for a number of years. The submitted budget usually undergoes several rounds of written revisions. The sectoral departments compile the proposals of various ministries into a sectoral proposal, which is passed on to the Budget Department. For instance, the Agricultural Department in MOF compiles the budgets for the Ministries of Agriculture, Forestry and Water Resources and the Bureau for Weather Forecast into a budget for "Agriculture."

The compiled sectoral budgets are submitted to the budget department of MOF. The budget department compiles the Central budget and aggregates the local budget estimates to the Central budget to compile the State budget (for general government).

The local government budget cycle starts considerably later than the Central budget cycle, in some localities as late as March. Local bureaus submit their budget estimates to the local budget department of the finance bureaus, which, after negotiation, pass on the budget to the Mayor's meeting, in which outstanding issues are settled. In the localities visited by the mission, the original budget draft of the line bureau was submitted for the Mayor's meeting, together with the finance bureau's comments. The Mayor's meeting should come to agreement on outstanding issues, before submitting the draft to the Local People's Congress.

Zero-Based Budgeting. To move away from the incremental base number technique, several local governments are experimenting with ZBB since 1993. ZBB puts more emphasis on the planned activities of a spending bureau rather than on last year's budget. In principle all expenditure proposals are reviewed, not just the increment over last year's budget. Expenditure norms for office expenses are included in the finance bureau's budget circular. The spending bureaus are required to put considerable detail on its "special projects" in the budget draft, which allows the finance bureau to probe the proposed expenditures more thoroughly, and to better assess the expected outputs of the bureau. According to the local authorities, their budgeting practice also puts more emphasis on controlling personnel costs as the more detailed budget proposals allow for a check of actual personnel rather than the quota of personnel assigned by the Personnel Bureau. The local authorities state that the ZBB technique has enabled them to better control overall expenditures, control wage costs and readjust expenditures in priority areas. However, they feel that the technique has its limits, because a large part of the budgets consists of personnel costs ("meal finance") which cannot be altered through the budget process.

Macroeconomic Coordination. During the fall, MOF, SPC and the PBC consult with each other on the budget plans and on the budgetary contribution to the investment plan. MOF negotiates with ministries on their budgets and with local governments on the central contributions to the local budgets and the local contributions to the central budget. In November/December, the National Finance and National Planning Conferences finalize the investment plans and budget proposals of ministries and localities. MOF compiles the budget results, and presents this to the State Council for review and approval.

Although the MOF has started a five-year rolling budget plan, there seems to be no coordination with SPC's five-year rolling investment plan. Recurrent costs for government investment projects are determined at the end of the investment construction, and only then taken into account in the budget.

Budget approval. After State Council review and approval, the "main contents" of the draft budget are submitted in February/March to the Standing Finance and Economics Committee of the NPC for detailed review. In March, the Minister of Finance presents the budget speech to the People's congress, and the Standing Committee presents a report on the draft budget. The NPC approves the budget on the basis of the speech and the report. The budget has legal status after NPC approval. After approval of the Central budget, MOF informs the ministries on the approved budget. In turn, the ministries inform their units on their budgets. Usually, by the end of April, all central units know their budget. At the local level, this may take until end of May.

Extra-budgetary Plan. State Council circular No. 29 orders an annual extra-budgetary plan to be prepared, but in practice this is not yet done, except for the 13 funds that are now included in the budget. MOF issued the regulations "Notice on formulating the Plan for Extra-budgetary Revenues and Expenditures" in early 1997.

Budget Adjustment. Budgets can be adjusted by (a) a budget adjustment passed by the Standing Committee on Finance and Economics of the NPC and (b) adjustments made by Government. The Budget Law gives no clear guidance as to the circumstances in which either method may be used, but in practice only method (b) is used. Budgets are adjusted regularly, and spending units and ministries continue to propose additional spending measures during the year. The reason for this is that revenues are always larger than budgeted. Criteria for approval of additional expenditures are unclear and seem to blur the original intention of the budget to some

extent, as the expenditure distribution in the final accounts differ significantly from those in the budget.

Payment Process

Budgetary Expenditures. Together with the budgets, monthly or quarterly budget plans for the spending ministries are approved. These plans serve as guidance for disbursements from the Treasury. Disbursements take place in two ways: (a) "general use" method and (b) "quota" method. Personnel and office expenses are usually governed by the quota method; special purpose expenditures by the general use method.

General use method

- The spending units submit a request for funds to their supervising ministries. Spending units have their own bank accounts, but they do not submit a copy of their bank statement together with the request for funds. The ministry consolidates the spending units' requests and submits a request for funds to MOF.
- The relevant MOF sectoral department scrutinizes the request of the ministry and hands it to the MOF budget department, accounting division. The accounting division in the budget department issues a payment order to the treasury department of PBC.
- The PBC National Treasury Department (NTD) fills out a payment form and submits that to the accounting department of PBC, which then authorizes transfer from the treasury account. The authorized payment form is brought to the Beijing branch of the PBC, which submits it to the clearinghouse. Funds are then transferred to the accounts of the relevant ministries in the Specialized Banks.
- The ministry transfers the funds to the spending units' account in a state bank. The spending units then make the payments from their bank accounts.

Quota method

- The spending units submit every quarter a quota request to the supervising ministry, which submits a consolidated request for the quarter's quota to MOF.
- After review by the sectoral department, MOF budget department notifies the NTD, which then issues a quota form to the spending ministry and its bank. The quota is regarded as a letter of credit by the bank, which then entertains requests from the spending ministry for allocation or actual expenditure against the quota. No commission is paid to the bank.
- At the end of each day, the bank clears the balance of the spending units at the local PBC branch, MOF transfers a "refund order" to the treasury, which differs from the payment order, but is treated in the same way.

- The capital construction department of MOF approves budgetary expenditures for capital construction. After approval, accounting division of MOF's budget department releases the payment order. The payment order is sent to the China Construction Bank. At the end of the month, the banks report to NTD on their disbursements against the quota. The NTD requests MOF for a reimbursement of the quota account.

NTD reported that the quota method was taken from the Soviet system in the 1950s. The credit supplied by the banks through this method was said to compensate for the treasury money that was in commercial banks at any point in time. In 1996, about Y20 billion or less than 4 percent of total expenditures was made by quota.

Subsidies for lossmaking enterprises are not treated as expenditures but as refunds on taxes, both in the budgetary accounts and in the expenditure process. The enterprise applies for such subsidies through the supervising ministry, which submits a consolidated request to MOF. Upon receipt of the payment order, the Construction Bank transfers money to the accounts of spending ministries, which transfer the money to the bank accounts of the spending units. The account in the Construction Bank is replenished from the Treasury account by bills of exchange approved by MOF.

Certain budgetary interest rate subsidies are also authorized by the Capital Construction department, but are transferred from the treasury to the State Development Bank (SDB) which has taken over part of the policy lending from the State Banks. The SDB uses the People's Construction Bank of China as a disbursement agent.

Tax refunds (e.g. for value added tax paid on exported goods) are applied for at the tax bureau, which reviews the application, and after approval sends the application to MOF or the finance bureau. MOF or finance bureau issues a "refund order" to the treasury, which transfers the money to the enterprise or, where applicable, to the ministry that made the application. The new system of credit invoice VAT, combined with a surge in exports since 1994, has caused some cash flow problems for the treasury.[1] To counter this problem, refunds were previously paid in installments. On July 1, 1995, the crediting of invoices was restricted to 14 percent, instead of the 17 percent VAT rate; since January 1, the refund rate is further reduced to 9 percent.

Extra-budgetary Funds. EBFs are disbursed by a different procedure than that for budgetary funds. Since no budget for EBFs is passed, the use of the funds is determined during the budget year. Extra-budgetary revenues are now kept in a "special fiscal account" by the finance bureau. This differs from the practice before State Council circular No. 29, when the funds were kept in a "special account." The difference is that EBFs are now no longer considered as owned by the collecting unit. The spending unit only has a transit account for extra-budgetary receipts, and an account for extra-budgetary expenditures. All extra-budgetary accounts, including the one of the finance bureau/MOF is held in a commercial bank.

Each spending unit submits a request for the disbursement of EBFs to its supervising agency. After review and approval, this is passed on to the finance bureau/MOF. The units request either monthly, quarterly, or ad-hoc funds. Monthly or quarterly requests for funds usually concern wages or office costs. Ad-hoc requests are made for special projects. The request form has three copies: one for the applicant, one for the supervising agency and one for the finance bureau. After approval, the finance bureau issues a payment form, which it passes on to its bank. The form has 4 copies: two for the finance bureau–one before and one after the funds transfer–and one each for the bank of the finance bureau and for the bank of the spending unit.

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[1] In 1994, refunds were about 50 percent higher than in 1993.

After approval, approved funds are transferred from the Finance Bureau's special account to the spending unit's extra-budgetary expenditure account from which payments are made.

Reporting. The central treasury reports daily, monthly and annually to MOF, both on its own operation and on the operations of treasuries at provincial level. Daily and monthly reports consist of aggregate numbers on revenues, expenditures, and treasury account balances. Over ten expenditure items and the main revenue items are reported. Annual reports provide detailed reports on all revenue and expenditure items. Lower level treasuries report both to the finance bureau at the same level and to the treasury one level above. Once revenues enter the county treasury, it takes about eight days before the revenues are reported to the central treasury, if the county is not computerized. About 25 percent of the counties are computerized.

Spending units report monthly and annually to supervising ministries, which compile reports for MOF. MOF, however, only substantially evaluates the annual reports. The tax administration reports daily, monthly and annually to the finance bureaus at the same level and to tax bureaus one level above.

Final accounts. At the March session of the NPC, the Finance Minister presents preliminary final accounts for the previous year. The final accounts are presented to the Standing Committee of the NPC in June/July. Final accounts are compiled by MOF, on the basis of the final accounts drafted by the spending ministries and the final accounts of the NTD. The spending units and ministries submit a bank account statement together with their final accounts. Audit Authorities of the People's Republic of China audit the final accounts.

ANNEX 2:
EXPENDITURE MANAGEMENT ISSUES RAISED IN BUDGET SPEECHES 1992-1997

Year	Issue
1992	• Administrative expenses much more than budgeted
	• Budget categories do not reflect priorities
	• Appropriate control over future bonds issue
	• Give more attention to financial work
	• Raise efficiency
	• Finance losses in excess of the contracted amount
	• Tax exemptions
	• Smooth sale of treasury bonds
	• Effective control over expenditures
	• Arbitrary extra-budgetary expenditures
	• Clean government
	• Careful audit and supervision
	• Combat formalism, reduce number of meetings
	• Reduce number of celebrations
	• Reduce expenditures on excess staff
	• Control soaring health care costs by shifting responsibility to health institutions
	• Purchase of new equipment by departments
	• Increase in discipline of state finances
1993	• Reviewing and rectifying the scope of expenditures and improving the management of finances
	• Some localities not able to meet normal payroll
	• Launching of too many projects
	• Overstaffing, causing total expenditures for personnel to be excessive
	• Macroeconomic control needs to be improved and strengthened
	• Leaders in localities should pay more attention to financial work, improve management expertise of finance, tax workers
	• Find new ways to efficiently manage funds for supporting agriculture
	• Unplanned development and redundant construction furthered by inappropriate administrative interference and preferential policies

- Control over expenditures, putting stop to extravagance and waste
- Strictly enforce the system for budget adjustment
- Reduce number of meetings and documents
- Institutions should improve the management of their funds, incorporating both funds allocated by financial departments and their earnings into a unified plan for revenues and expenditures (24)
- Exercise strict control over extra-budgetary funds (24)
- Scientifically define the state's function in the management of society (24)
- Give full play to the supervisory function of the finance departments
- Review all finance and taxation laws

1994
- Expenditures exceeded budgeted amount by big margin
- Starting projects at random
- Spending administrative funds on unnecessary new and foreign items
- Extravagance and waste
- Acute problem with supply and demand of funds
- Some localities not able to meet their normal payroll
- Making management of finances more standardized, better legal framework
- High expenditure base for 1993 made it necessary to increase essential expenditures spent on agriculture, education, science, technology and other key areas.
- Reductions in revenue, increases in expenditure, compliance with budget
- Legal footing of financial management
- Reform method of issuing treasury bonds
- Controlling overall expenditure, funding for key projects
- No new project launches
- Abandon projects without funding or with unclear future
- Wasted funding
- Travel under pretext of holding meetings
- Wine and dine
- Deepen reform of financial management in public institutions (29)
- Proceeds from land use, sale of public housing and other form of revenue which should come under budgetary control should come under budgetary control (29)

1995
- Expenditures exceeded the budgeted figure by a fairly large amount
- Problem of weak financial budget restrictions still remains unsolved (p5)
- Losses and wasting of revenues are still very common. (6)
- No big adjustments have been made in the original pattern of distribution of interest (6)

- Our macro-regulating capacity is clearly insufficient (6)
- Some localities were not even able to pay wage increases or even guarantee the normal payroll
- Because all fields of endeavor have, in recent years, been calling for increased expenditures to accelerate development financial expenditures have stayed 2 to 4 percent higher than the increase in revenues (11)
- There is great potential for cutting down expenditures
- Local governments should pay close attention to adjusting the pattern of utilization of funds for agriculture and concentrate on supporting agricultural infrastructure facilities.
- Poor performance of SOEs
- Separate functions of government from those of enterprises
- Guarantee funding for key projects while cutting back on general spending
- Continue to increase investment in such key areas as agriculture, education, science and technology
- High priority to meet the payroll and carry out wage reform measures introduced last year
- Waste is due to inaccurate feasibility studies, factors related to price rises, improper management of construction funds and losses in the process of project subcontracting (22)
- Tighten control of institutional spending through financial management.

1996

- Budget overruns were in evidence only in the local budgets (6)
- Some central budget expenditure came from local governments in implementation of the budget, thus increasing actual local spending (6)
- We introduced a system whereby central government checked on quotas for administrative expenditures an the provincial level
- Some regions implemented a zero-based budgeting system
- Central finance still has problems
- An effective solution has not yet been found to the problems of the transformation of budgetary into extra-budgetary funds (7)
- Expenditures still grew too rapidly (7)
- The problem of back wages owed to office staff and workers in administrative departments and institutions still exists in some localities
- Diverting funds for agriculture to other purposes
- Straighten out the distribution relationships (19)
- Operation of the revenue sharing system at and below the provincial level
- Some local governments have converted budgetary funds into extra-budgetary funds without authorization to evade budgetary management and supervision. The common practice of establishing private funds has become a source of indiscriminate

distribution of bonuses, extravagance and squandering (22)

- These problems have not only become a great drain on the state tax revenue and assets, disrupted fair competition and market order and adversely affected the effective implementation of state macro-control policies, but also corrupted some cadres (22)
- We should improve the management of extra-budgetary funds. All items that should be subject to budgetary control according to the decree of the State Council must be incorporated into the budget (22)
- Concentrate on uncovering such problems as keeping two accounts, tax evasion, conversion of budgetary funds into extra-budgetary funds and unauthorized private funds (23)
- We shall carry out overall checks on the use of extra-budgetary funds (23)

1997

- The deficit in the central budget is still too large (6)
- Because expenditures are not effectively controlled, they increase at a high rate (6)
- Extravagance and waste are prevalent (6)
- The unauthorized establishment of funds and the collection of arbitrary charges is still prevalent (6)
- The diversion of state financial resources has not been checked (7)
- Prevent extensive investment and avoid rushing headlong into action without considering feasibility (14)
- Step up our efforts to cut down the number of meetings, strictly control and approve the traveling expenses for Party and government officials who go abroad and resolutely put a stop to the unhealthy practices of holding banquets and going sight-seeing at public expenses (16).

Stated Goals in Budget Speeches 1992-1997

Year	Goal
1992	• Financing of economic development • Fight natural disaster • Support Reforms in all fields • Increase investment in agriculture, science, technology, education and other key sectors • Invigorate large to medium SOEs (LMSOEs) • Appropriate subsidies to staff of administrative departments and government institutions for grain price rise • Continue to aid poor regions • Clean up chain debt
1993	• Increase investment in agriculture • Invigorate LMSOEs • Increase investment in science, technology and education • Stress key sectors • Economic development is central task • Decrease of unprofitable enterprises in the budget
1994	• Continue to strengthen and improve macro-regulation • Promote overall development of the rural economy • Improve operation of LMSOEs • Increase investment in science, technology and other key areas • Improve macro-control and promote rapid and sustained development
1995	• Further adjust the pattern of expenditures • Increase expenditures for further building up the national strength • Practicing strict economy and build up the country through thrift and hard work, make overall plans and take all factors into consideration and ensure the construction of key projects (7) • Curbing inflation and reducing the excessively high price index • Continue to ensure the grain risk fund and the non-staple food risk fund (11) • Increase subsidies for minority areas (18) • Paying special attention to the quality and efficiency of economic growth (19)

1996

- Adopt a relatively stringent fiscal policy, support economic development, continue to improve the reform of finance and taxation, work to rectify the financial and economic order, tighten control over expenditures, oppose all forms of extravagance and waste and strive to reduce the deficit (8)
- Basically eliminate the deficit over the Ninth Five-Year Plan (12)
- Ensure adequate investment in key projects
- Increased income should be mainly used to solve the problem of overdue wages, ensuring key expenses and paying off past financial debt
- Tighten control over use of funds and ensure better results for expenditure (12)
- In education, science and technology, more money should be spent on improving and updating existing teaching and research facilities, and not on launching new projects (13)
- Do all we can to prevent the diversion of funds earmarked for key projects to any other purpose (13)
- Try and spend less money doing more (13)
- In the management of expenditures we should continue to strictly carry out a relatively stringent financial policy, readjust the structure of expenditure and make sure that the expenditures that should be cut are cut without fail. We should thoroughly fight corruption to put an end to evil practices in the use of public funds such as extravagance, waste and ostentatious behavior and tighten the control over expenditures (21)
- In managing expenditures, we should work to review and spread useful experiences and methods for reducing expenditures (21)

1997

- Make support of agriculture a priority in our financial work (13)
- Promote the two fundamental shifts in the economic system and the mode of economic growth (14)
- Priority to reducing administrative expenditures (15)
- Collect the land use receipts which have not been turned over to the state finance (15)
- The increase in expenditure must be lower than the revenue (15)
- The pattern of expenditures should be readjusted (15)
- We must strictly control the size of staff in state organs
- Stop providing administrative funds to some units which have ceased to perform the functions of administration (16).

ANNEX 3:
EXPENDITURE NEEDS FOR PRIORITY AREAS

Underfunding of priority activities, including infrastructure, the environment, health and education services and poverty alleviation, which perpetuate unacceptably poor living conditions for a large segment of the population, may threaten the sustainability of growth. This annex presents some estimates of the extent to which government budgetary expenditures in the social sectors and in poverty alleviation fall short of needs.

Education and health

China's record in human capital formation has been impressive and its social indicators are high in comparison with low-income countries, approaching those in higher middle-income countries. However, recent years show a declining trend in social sector spending, eroding China's favorable standing among comparable Asian countries.

Public expenditures on education declined from 3.1 percent of gross domestic product in 1985 to 2.4 percent in 1994 and again to 2.05 percent in 1995. This is in contrast to the Asian NICs, where steady increases in public spending on education (especially basic education) played a fundamental role in sustaining their high growth. And relative to its East Asian neighbors, China's spending has been decreasing since 1985, and now is the lowest in the region (see Table A3.1). Part of China's declining share of education expenditures in gross domestic product may be explained by demographics and China's one-child policy. Also, fees and self-raised funds have increasingly supplemented budgetary resources, raising the burden on poor households and reducing their access to schools.

Table A3.1: Public Expenditures[a] on Education
(Percent of GNP)

	1985	1989	1992
Hong Kong	2.8	2.8	2.9
Korea, Rep. of	3.0	3.6	4.2
Singapore	5.0	3.4	4.4
Malaysia	7.9	5.6	5.5
Thailand	3.2	3.2	4.0
Indonesia	2.3	-	2.2
China	3.1	2.7	2.1

[a] Include budgetary expenditures, extra-budgetary expenditures from educational surcharges, and SOE expenditures on education.

Source: Ministry Of Education; State Statistical Yearbook (1995); ADB 1995; *China: Social Sector Expenditures*, World Bank, (1995) and World Bank (1994): East Asian Miracle report

Overall spending on health has also been declining as a share of gross domestic product. While China's national health indicator compare favorably to other countries with similar per capita income levels, these indicators hide substantial regional variations. For example, infant mortality rates in the South Hinterland are nearly three times as high as those in coastal areas (see table A3.2). Access to adequate health care remains a problem for large segments of the population and affordability is a growing concern.

Inequalities in education and health care–both in terms of outcomes and expenditures–remain large (see Table A3.2). Provinces with lower per capita incomes and a higher proportion of minorities tend to have weaker social indicators. For instance, functional illiteracy rates in the Far West and South Hinterland are the lowest in China, twice those on the South Coast. The divergence in school attendance among the regions would predict persistence in these patterns.

Table A3.2: Regional Education and Health Indicators, 1995

	GDP Per Capita	Minority Population Share (%)	Functional Illiteracy Rate (%)	Basic Education Expenditures (per student)	6-14 Year olds in School (%)	Population: Natural Rate of Increase (%)	Per capita Health Expenditure (1994) yuan	Infant Mortality (per 1000) (1993)
China	4,772	9.0	12.0	614	82.3	10.6	12.5	33.0
East Coast	8,848	0.4	11.5	1,335	89.3	5.0	16.6	17.6
South Coast	7,449	2.1	9.8	934	89.0	11.6	18.6	17.9
North Coast	5,557	5.0	11.4	456	87.6	5.3	10.8	14.9
North Hinterland	4,018	6.9	9.7	617	82.0	9.0	13.2	24.4
Far West	3,267	34.9	19.9	613	78.2	13.8	19.6	44.4
Central Core	3,467	2.9	12.1	764	82.7	8.6	7.7	43.8
South Hinterland	2,956	14.6	15.3	712	75.8	11.0	10.1	50.5

Source: World Bank (1995); 1996 State Statistical yearbook; 1995 Nian Quanguo 1 percent Renkou Chouyang Diaocha Zhuyao Shu Ju (Main Statistics from the 1995 one percent Population Census), SSB, 1995; 1995 Educational Statistics Yearbook of China; 1995 Health Yearbook of China.

Disparities in government spending contribute to this outcome. These disparities are large and have grown with greater fiscal decentralization. The poorest regions with the weakest fiscal base have the lowest per capita expenditures, which are matched with the highest private fees. However, many of the poorer regions also have a large share of minorities, which adds to the cost of education. Guizhou spends less then 40 Yuan on basic education per capita while Shanghai's figure is over 200. Disparities among local budgetary health spending show a similar pattern. Whereas Anhui spends less than 7 Yuan per capita a year, Shanghai spends over 40.

Inequalities in access and care have been exacerbated by changes in the structure of health care financing. The shift in health care finance towards insurance and insurance coverage tends to concentrate health care benefits on the urban population, especially government employees. Except for about 100 million of the highest earners, the rural population is uninsured. Over the reform period, health financing has shifted from the government budget and collective health schemes toward insurance and user fees. Whereas the government financed 25 percent of health expenditures in 1980, it only financed 13 percent in 1992–below levels in most Asian comparators. Rural collective funding declined even more sharply, from 16.7 percent of health expenditures in 1990 to 5.5 percent in 1992, thus leaving most of the rural population paying user fees. These fees now finance over a third of expenditures.

The government can arrest a possible deterioration in China's social indicators, mitigate disparities in educational attainment and health status and promote growth by increasing the level of public expenditures allocated to basic education and health. To achieve the goal of universal access to good quality basic education, government expenditures on basic education would have to rise from the current 1.8 percent of gross domestic product to 2.9 percent of gross domestic product. Of the 1.1 percent rise in expenditures, about 0.7 percent is necessary to bring the

expenditures per student in basic education to acceptable levels.[1] The rest is necessary to increase the enrollment ratio from the current 82 percent to 100 percent.

The package of public health and essential clinical services that is recommended in the *World Development Report 1993* requires resources equivalent to 3.5 percent of gross domestic product for the whole population. A public health package alone–arguably a government responsibility–would require budgetary expenditures of 1.5 percent of GDP in 1995, more than three times the current government spending on health.

Poverty Alleviation

Poverty alleviation is a major priority for the Ninth Five-Year Plan period and China has raised expenditures on poverty alleviation commensurably. Public expenditures on poverty alleviation have increased rapidly in the past several years and are now comparatively higher than for education and health. But higher levels still are needed to meet the objectives of the National Seven-Year Plan for Poverty Reduction (8-7 Plan), to reach the rural poor residing outside the targeted 592 counties and to address the growing problems of the urban poor.

The extension of the multi-pronged approach adopted in the Southwest Poverty Reduction Project to all the poor in China would necessitate annual expenditures of about Renminbi 18 billion or 0.33 percent of gross domestic product in 1995. This is only slightly more (0.26 percent of 1995 GDP) than the 15 billion planned for poverty spending annually for the rest of the Ninth Five-Year Plan period. Refinements in approach (such as targeting below the county level) could further improve the impact of the government's poverty alleviation efforts.

Environment

In addition to more effective regulatory control, in particular over TVEs, and appropriate pricing to dampen demand and reduce pollution, there is a need for allocating increased resources toward meeting the investment and operating costs of municipal services, including sewerage, wastewater treatment and solid waste management. China increased spending on pollution control, from 0.4 percent of GDP in 1980 to 0.67 percent in 1992, but this remains insufficient to deal with the nearly threefold increase in the output of heavy industry over the same period (international comparisons). Total suspended particulate (TSP) levels remain well above levels considered safe by the World Health Organization, sulfur dioxide concentrations exceed the lowest Chinese air quality standard. Few urban rivers reach the lowest acceptable Chinese water quality standard and groundwater quality continues to fall at an alarming rate. Petroleum discharges to surface waters are increasing after an initial decline. Only 4.5 percent of municipal wastewater flows receive treatment of any kind, while industrial pretreatment raises overall treatment rates to 17 percent. The Government's goal for the year 2000 is a modest 25 percent. Nearly 40 percent of urban China is unserved by sewers, with wastewater going directly into lakes and rivers, and according to current municipal investment plans, 30 percent of urban China will still remain unserved in the year 2000.

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[1] We chose Zhejiang Province as representative of an "acceptable" expenditure level. Zhejiang is the non-city province with the highest expenditures after Guangdong.

Given the impact of untreated wastewater outside the producing municipalities–downstream effects and widespread aquifer pollution–central government intervention appears necessary to safeguard water quality in China. A wastewater investment program, which would provide treatment for any discharge that reduces receiving water quality to below irrigation use standards, would cost about 4.2 billion Yuan per year over the next ten years, requiring an increase of 15 percent in the annual urban infrastructure construction program. Improved solid waste disposal (through landfills) might cost about 5.2 billion yuan/year (8 in 95 prices) or 16 Yuan/capita/year–more than three times current charges for domestic waste. While the incremental cost of these interventions is a modest 0.3 percent of GDP (0.2 percent in 95 prices), cost recovery through increased user fees would result in a tripling of average effective water prices.

Estimates of investments required to improve waste treatment and water supply in cities where there are severe shortages are in the order of RMB100 billion/year over the next 10 years or 1.7 percent of 1995 GDP. This compares with current urban water investments of only 0.35 percent of GDP. Substantial budgetary funds are expected to be necessary for inter-basin transfer projects (15 to 30 percent of project costs) and sewerage and industrial waste management (30 percent), yielding budgetary requirements of 0.3 percent of GDP.

Infrastructure

China needs greater public expenditures in infrastructure. This is not to deny that China has made tremendous strides in infrastructure investments in the last ten years. These amounted to 7.5 percent of GDP in 1994, up from 4.4 percent in 1985. Higher tariffs (e.g. power) and government-directed credit have been the principal sources of finance with only a small contribution from budgetary funds. This has resulted in underfunding of infrastructure projects that are not commercially viable but yield large economic benefits.[2] Of particular concern, in this regard, is China's road infrastructure. Physical indicators show that China fares relatively poorly in comparison with other large countries in per capita coverage of the road network. It is therefore reasonable for China to aim for 8-9 percent of GDP and to channel increased budgetary funds of some 0.5-1.0 percent of GDP to infrastructure investments with public goods characteristics.

Contingent Liabilities

Public expenditure policies will have to address not only the underfunding of priority sectors discussed above, but also manage the implications of increased market orientation for the budget. Tasks previously performed by other sectors of the economy will increasingly be shifted to the budget, while in-kind benefits offered to civil servants will be monetized and contingent liabilities may increase. The implicit pension debt is estimated to equal around 50 percent of GDP and according to official estimates, about 20 percent of the state bank portfolio are nonperforming, which equals another 20 percent of GDP. In addition, with economic growth and rapidly rising wages, government services are likely to become relatively more expensive, necessitating a larger government share of the economy.

[2] In 1992, the budget financed 7.4 percent of infrastructure investments, a share marginally higher than the contribution of the budget to all state investments. China: Public Investment and Finance, World Bank, 1995.

Pension reforms appear to be gaining momentum. It is important to evaluate carefully the budgetary implications of various options. The government now appears to be favoring a multi-pillar approach, the first of which would have welfare and redistributive objectives and be funded on a pay as you go basis. Fully funded mandatory individual retirement accounts would consitute the second pillar and a voluntary scheme the third. A difficult issue that remains to be resolved concerns the transition from the current unfunded to a largely funded scheme in the future.

Pension expenditures now account for some 2 percent of GDP and yield benefits that amount, on the average, to 70 percent of wages. The bulk of these payments (excluding civil servants) are now assumed by enterprises. Under the proposed scheme, the government would assume responsibility for the basic benefit, which the Bank proposes should equal 24 percent of wages, and transition costs.

The first pillar would be financed out of a payroll tax equivalent to 6 percent of wages. The costs of transition in 1994 (1.3 percent of GDP) could be financed out of the surplus generated from the first pillar, a reduction of benefits and government borrowing or sale of SOE assets. Assuming an even split of the burden between government and SOEs would yield budgetary expenditures for 1994 of some 1.35 percent of GDP, 0.9 percent of which would be covered by the payroll tax.

Unemployment benefits will rise with increasing open unemployment in urban areas. Assuming benefit levels equivalent to the public pillar of the pension scheme and 5 percent urban unemployment, budgetary outlays would equal 0.2 percent of GDP and could be financed by a payroll tax of 1-1.5 percent.

Budgetary Expenditures Revisited. Adjusting the level of budgetary spending to reflect the need for additional expenditures in priority areas (as discussed above), and the implicit and extra-budgetary costs of all government activities yields budgetary expenditures in 1995 of some percent of GDP (Table A3.3). This is substantially higher than current budgetary expenditure levels and closer to international norms.

Table A3.3: Proposed Expenditures: Cost of Shouldering Government Responsibility

Expenditures	Percent of GDP
Actual Budgetary Expenditures,1995	
Extra-budgetary Expenditures	
Additional Expenditures Proposed	5.35
Education	(1.1)
Health	(1.5)
Poverty Alleviation	(.05)
Environment	(0.5)
Infrastructure	(0.7)
Social Insurance	(1.5)
Adjusted Budgetary Expenditures, 1994	

ANNEX 4:
CHINA'S FISCAL PROSPECTS IN THE MEDIUM TERM[1]

Summary

The Staff's medium-term economic projections assume that the macro-economic performance achieved recently can be sustained in the medium-term. Combined with an assumption of unchanged tax policies, the revenue-to-GDP ratio can be expected to increase only modestly (probably less than one percentage point) in the years to 2010. The revenue ratio is projected to increase by about 3/4 percentage point to the year 2010, mainly as a result of a continued increase in household consumption and hence in consumption taxes and a buoyant personal income tax.

Significant off-budget expenditures in China are financed through the social funds and the EBFs. According to some estimates, the related revenues and expenditures constitute close to 7 percent of GDP. Against this background, a medium-term fiscal framework must necessarily build upon the consolidated operations of the state budget and all off-budget funds.

The goals and objectives for the medium-term for key sectors of the economy, as stated by the Chinese authorities, imply that the budget will probably need to assume significant new expenditure burdens if the present momentum of economic development is to be sustained. Sizable expenditure demands are expected, mainly in three broad areas. Increases in physical infrastructure investment demands are foreseen for housing and highway construction, agricultural development and power generation. Similarly, significant social infrastructure demands will result from the establishment of a modern social safety net, including pension and unemployment funds. Large additional resources will also have to be devoted to financial infrastructure investment, primarily to clean up bad debt in the banking sector with a view to creating a sound financial basis for a market-based economy. The resulting overall expenditure demands can only be projected with considerable uncertainty and will almost entirely depend on specific political decisions. Hence, the numbers used in the medium-term projection within the different areas should be considered merely as technical working hypotheses at this stage.

To the extent that the prospective expenditure demands, whether deriving from the move on-budget of extra-budgetary activities or from new expenditure demands, will affect the fiscal balance, the authorities must seek to assess the possible magnitude of the resulting financing needs. Following the need to maintain the objective of a zero fiscal deficit in the medium-term, the prospective expenditure demands will have to be met by new revenue measures.

[1] The numbers used in this annex differ slightly from those of the main text and of Annex 3, due to different assumptions and definitions.

The Macroeconomic Framework

The basis of the fiscal projection to the year 2010 presented below is a macro-economic framework which basically assumes that the impressive macro-performance achieved in the most recent years can be sustained in the medium term, characterized by a high level of non-inflationary growth of about 9 percent from 1998 and onwards (see Table A4.1 for details). On the demand side, private household consumption is assumed to continue its increase relative to GDP, whereas public consumption and fixed investments are assumed to stabilize as a percentage of GDP. The level of openness of the Chinese economy is assumed to continue to increase, albeit only modestly, as reflected in growing import-and export ratios, from about 18-19 percent in 1997 to about 21 percent in 2010.

Key to the projection of fiscal revenues is the expected developments in the functional distribution of income. In this regard, the projection assumes that aggregate wage incomes, concurrently with the maturing of the Chinese economy, will constitute a growing share of total factor incomes, increasing from the present (and very low) level of about 15 percent to about 20 percent over the next 15 years.

A Fiscal Benchmark Projection

Generally, in the short run, there is no simple and stable relationship between tax bases and macro-economic (SNA) aggregates. Over the medium- and long-term, however, it is reasonable to expect that systematic changes in macro-aggregates, under an assumption of unchanged policies, will be reflected in corresponding changes in tax bases, and hence in tax yields from consumption, income and trade taxes. The projection presented here (see Table A4.2) assumes such a relationship. Concerning income taxes, the personal income tax is assumed to be positively affected by the relative increase in wages, as well as by the nominally fixed tax threshold, which have significantly contributed to the high buoyancy of this tax in recent years (with yields increasing by almost 50 percent in 1996). With revenues at 0.3 percent of GDP, the PIT at present contributes very little to overall revenues and its high buoyancy cannot alter the fact that overall taxes related to income and profits (including the enterprise income tax) will continue to contribute less than 2 percent of GDP in the projection period. Regarding consumption taxes (VAT + excises), the assumed increase in private household consumption will tend to marginally lift the yield, and over the whole of the projection period the projection foresees an increase in these taxes of only about 0.5 percent of GDP. A similar development is projected for trade taxes, resulting from the assumed increase in the import ratio.

Over the period of time discussed here, expenditure developments can broadly be considered the cumulative outcome of explicit policy choices rather than a reflection of underlying structural trends or economic cycles. This highlights the importance of the assumptions made concerning the nature of "unchanged policies". In the present projection, subsidies (to SOEs and price subsidies) are assumed to stabilize at the historically low level of about one percent of GDP from 1997 and onwards. Owing to the strong expansion of bond financing (bond issuance is expected to increase by about 25 percent from 1996 to 1997), interest expenses in the budget have increased and is expected to continue to do so albeit from a very low level. Because of the lowering of the state budget deficit

Table A4.1: Macro Framework

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Nominal GDP	3463.44	4662.23	5826.05	6780	7869.55	9092.47	10505.44	12137.99	14024.23	16203.6	18721.64	21630.99	24992.46	28876.79	33363.68	38548.41	44538.84	51460.19
Growth in percent	30.02	34.61	24.96	16.37	16.07	15.54	15.54	15.54	15.54	15.54	15.54	15.54	15.54	15.54	15.54	15.54	15.54	15.54
Real GDP (1990 basis)	2627.72	2598.81	3269.49	3586.63	3927.36	4280.82	4666.1	5086.04	5543.79	6042.73	6486.58	7197.37	7825.51	8529.81	9297.49	10134.26	11046.35	12040.52
Growth in percent	13.5	12.6	10.5	9.7	9.5	9	9	9	9	9	9	9	9	9	9	9	9	9
Demand components:																		
Private consumption	1631.5	2199.07	2813.24	3237.22	3807.64	4443.11	5152.79	5999.12	7003.14	8192.05	9521.26	11044.13	12810.38	14858.87	17234.67	19999.04	23185.57	26891.54
Public consumption	424.2	538.50	635	721	826.3	972.89	1155.6	1359.45	1584.74	1831.01	2115.55	2444.31	2824.15	3263.03	3770.1	4355.98	5032.9	5815.01
Fixed investment	1298.0	1685.6	2000.1	2406.9	2770.08	3182.37	3624.38	4187.61	4838.36	5590.24	6458.97	7462.69	8622.4	9962.32	11510.47	13299.2	15365.9	17753.76
Private																		
Public																		
Inventory investment	201.8	173.6	277.91	332.22	409.22	454.62	525.27	546.21	560.97	567.13	608.46	670.57	737.28	808.54	884.15	963.72	1046.67	1132.14
Exports (goods and serv)	693.87	1026.18	1229.66	1281.78	1509.76	1727.78	1987.5	2282.6	2617.69	3000.89	3523.39	4135.82	4853.51	5694.38	6679.37	7833	9183.86	10765.42
Imports (goods and serv)	785.97	960.74	1129.8	1199.12	1453.46	1688.3	1940.1	2237	2580.66	2977.71	3505.97	4126.51	4855.25	5710.82	6715.06	7893.5	9276.03	10897.64
Functional income components:																		
Wage bill	491.6	665.6	850.98	1012.69	1201.4	1418.1	1673.14	1973.2	2326.12	2741.07	3228.82	3801.96	4475.26	5266.01	6194.44	7284.27	8563.23	10063.78
Profits, gross	2971.84	3996.63	4975.07	5767.31	6668.15	7674.37	8882.3	10164.79	11698.11	13462.53	15462.83	17829.04	20517.2	23610.29	27169.24	31264.13	35975.61	41396.42
Check (GDP-C-I-(X-M)=0	0.04	0.02	-0.06	0	0.01	-0.01	0	0	-0.01	-0.01	-0.01	-0.01	-0.02	-0.02	-0.02	-0.02	-0.03	-0.03
GDP ratios:	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Private consumption	0.47	0.47	0.48	0.48	0.48	0.49	0.49	0.49	0.5	0.51	0.51	0.51	0.51	0.51	0.52	0.52	0.52	0.52
Public consumption	0.12	0.12	0.11	0.11	0.1	0.11	0.11	0.11	0.11	0.11	0.11	0.11	0.11	0.11	0.11	0.11	0.11	0.11
Fixed investment	0.37	0.36	0.34	0.36	0.35	0.35	0.35	0.35	0.35	0.34	0.34	0.34	0.34	0.34	0.34	0.34	0.34	0.34
Private																		
Public																		
Inventory investment	0.06	0.04	0.05	0.05	0.05	0.05	0.05	0.05	0.04	0.4	0.03	0.03	0.03	0.03	0.03	0.03	0.02	0.02
Exports (goods and serv)	0.2	0.22	0.21	0.19	0.19	0.19	0.19	0.19	0.19	0.19	0.19	0.19	0.19	0.2	0.2	0.2	0.21	0.21
Imports (goods and serv)	0.23	0.21	0.19	0.18	0.18	0.19	0.18	0.18	0.18	0.18	0.19	0.19	0.19	0.2	0.2	0.2	0.21	0.21
Wage bill	0.14	0.14	0.15	0.15	0.15	0.16	0.16	0.16	0.17	0.17	0.17	0.18	0.18	0.18	0.19	0.19	0.19	0.2
Profits, gross	0.86	0.86	0.85	0.85	0.85	0.84	0.84	0.84	0.83	0.83	0.83	0.82	0.82	0.82	0.81	0.81	0.81	0.8

Table A4.2: Benchmark Projection - The State Budget

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Revenues	475.9	558.4	654	741.2	871.15	1015.74	1177.79	1369.27	1593.36	1856.62	2156.44	2501.58	2901.97	3364.49	3900.67	4522.26	5242.83	6078.15
Tax revenues	447.5	524	605.5	684	804.76	939.03	1089.16	1266.87	1475.05	1719.91	1998.49	2319.08	2691.12	3120.87	3619.2	4197.04	4867.08	5644
Income & profit taxes	80.5	94	110.9	123.55	145.54	170.9	199.18	232.21	269.46	312.72	362.97	421.34	489.15	565.95	654.8	757.6	876.54	1014.15
Enterprise income taxes	...	...	...	104.55	120.69	138.91	159.86	183.98	211.74	243.67	280.42	322.71	371.36	427.35	491.76	565.88	651.16	749.28
Personal income taxes	...	...	...	19	24.84	31.99	39.32	48.23	57.72	69.05	82.55	98.64	117.79	138.6	163.04	191.72	255.38	264.88
Consumption taxes	287.8	346.5	399	461.75	543.12	633.76	734.99	855.71	998.92	1168.5	1358.1	1575.32	1827.26	2119.45	2548.33	2851.35	3307.16	3835.78
VAT	108.1	230.8	258.6	298.29	350.85	409.41	474.8	552.78	645.3	754.85	877.33	1017.65	1180.4	1369.15	1588.07	1841.96	2136.41	2477.89
Other	179.7	115.7	140.4	163.46	192.27	224.35	260.19	302.92	353.62	413.66	480.77	557.67	646.86	750.3	870.26	1009.39	1170.75	1357.88
Customs duties	25.6	27.3	28.7	30	36.36	42.24	48.54	55.97	64.56	74.5	87.71	103.24	121.47	142.88	168	197.48	232.07	272.64
Other taxes	53.6	56.2	66.9	68.7	79.74	92.13	106.45	122.99	142.1	164.19	189.7	219.18	253.24	292.6	338.07	390.6	451.3	521.43
Non-tax revenues	28.4	34.4	48.5	57.2	66.39	76.71	88.63	102.4	118.32	136.7	157.95	182.49	210.85	243.62	281.48	325.22	375.76	434.15
Expenditures	545.9	632.6	751.8	867.96	1000.25	1164.78	1345.79	1554.93	1782.54	2051.45	2360.88	2716.95	3126.66	3598.11	4140.58	4764.75	5482.92	6309.24
Current	424.3	538.5	624	726.36	842.86	982.93	1135.68	1312.17	1502.06	1727.37	1986.45	2284.33	2626.81	3020.58	3473.3	3993.78	4592.15	5280.04
Subsidies	71	68	71.7	79.32	78.7	90.92	105.05	121.38	140.24	162.04	187.22	216.31	249.92	288.76	333.64	385.48	445.39	514.6
Interest expenses	9.7	16.7	35.6	49.7	70.83	90.92	105.05	121.68	126.22	137.73	149.77	162.23	174.95	187.7	200.18	212.02	222.69	231.57
Other	343.6	453.8	516.7	597.35	693.34	801.09	925.57	1069.41	1235.59	1427.61	1649.46	1905.78	2201.94	2544.13	2939.48	3396.28	3924.06	4533.86
Capital	121.6	94.1	127.8	141.6	157.39	181.85	210.11	242.76	280.48	324.07	374.43	432.62	499.85	577.53	667.27	770.97	890.78	1029.2
Balance	-70	-74.2	-97.8	-126.76	-129.1	-149.05	-168	-185.65	-189.18	-194.83	-204.44	-215.37	-224.69	-233.62	-239.9	-242.49	-240.09	-231.09
Ratios to GDP:																		
Revenues	13.74	11.98	11.23	10.93	11.07	11.17	11.21	11.28	11.36	11.46	11.52	11.56	11.61	11.65	11.69	11.73	11.76	11.81
Tax revenues	12.92	11.24	10.39	10.09	10.23	10.33	10.37	10.44	10.52	10.61	10.67	10.72	10.77	10.81	10.85	10.89	10.93	10.97
Income taxes	2.32	2.02	1.9	1.82	1.85	1.88	1.9	1.91	1.92	1.92	1.93	1.94	1.95	1.96	1.96	1.96	1.97	1.97
Enterprise income taxes	0	0	0	1.54	1.53	1.53	1.52	1.52	1.51	1.5	1.5	1.49	1.49	1.48	1.47	1.47	1.46	1.46
Personal income taxes	0	0	0	0.28	0.32	0.35	0.37	0.4	0.41	0.43	0.44	0.46	0.47	0.48	0.49	0.5	0.51	0.51
Consumption taxes	8.31	7.43	6.85	6.81	6.9	6.97	7	7.05	7.12	7.21	7.25	7.28	7.31	7.34	7.37	7.4	7.43	7.45
VAT	3.12	4.95	4.44	4.4	4.46	4.5	4.52	4.55	4.6	4.66	4.69	4.7	4.72	4.74	4.76	4.78	4.8	4.82
Other	5.19	2.48	2.41	2.41	2.44	2.47	2.48	2.5	2.52	2.55	2.57	2.58	2.59	2.6	2.61	2.62	2.63	2.64
Customs duties	0.74	0.59	0.49	0.44	0.46	0.46	0.46	0.46	0.46	0.46	0.47	0.48	0.49	0.49	0.5	0.51	0.52	0.53
Other taxes	1.55	1.21	1.15	1.01	1.01	1.01	1.01	1.01	1.01	1.01	1.01	1.01	1.01	1.01	1.01	1.01	1.01	1.01
Non-tax revenues	0.82	0.74	0.83	0.84	0.84	0.84	0.84	0.84	0.84	0.84	0.84	0.84	0.84	0.84	0.84	0.84	0.84	0.84
Expenditures	15.76	13.57	12.9	12.8	12.71	12.81	12.81	12.81	12.71	12.66	12.61	12.56	12.51	12.46	12.41	12.36	12.31	21.26
Current	12.25	11.55	10.71	10.71	10.71	10.81	10.81	10.81	10.71	10.66	10.61	10.56	10.51	10.46	10.41	10.36	10.31	10.26
Subsidies	2.05	1.46	1.23	1.17	1	1	1	1	1	1	1	1	1	1	1	1	1	1
Interest expenses	0.28	0.36	0.61	0.73	0.9	1	1	1	0.9	0.85	0.8	0.75	0.7	0.65	0.6	0.55	0.5	0.5
Other	9.92	9.73	8.87	8.81	8.81	8.81	8.81	8.81	8.81	8.81	8.81	8.81	8.81	8.81	8.81	8.81	8.81	8.81
Capital	3.51	2.02	2.19	2.09	2	2	2	2	2	2	2	2	2	2	2	2	2	2
Balance	-2.02	-1.59	-1.69	-1.87	-1.64	-1.64	-1.6	-1.53	-1.35	-1.2	-1.09	-1	-0.9	-0.81	-0.72	-0.63	-0.54	-0.45

and the trend towards declining interest levels, interest expenses are assumed to reach a maximum of about one percent of GDP at the end of the century and subsequently to decline at the end of the projection period. Other current expenditures are assumed to stabilize at close to 9 percent of GDP and capital expenditures are assumed to further decline and then stabilize at a historically very modest level of two percent of GDP.

Under these assumptions, the revenue ratio will increase over the projection period by a modest 0.75 percent of GDP, while expenditures can be expected to decline marginally by about 0.5 percent of GDP, leaving a deficit of about 0.5 percent of GDP in 2010. In other words, assuming unchanged policies, there are factors which will tend to improve the fiscal balance, an improvement estimated at a shade over one percent of GDP at the end of the projection period compared to the actual present level.

Sizable fiscal operations in China take place off-budget. This holds for the operations of the five social funds and the EBFs at both the central and the local levels. According to GFS principles, the majority of these operations should clearly be included in the recording of the operations of general government. Since these funds–according to some estimates–have reached an overall level close to 7 percent of GDP, and since they conduct key functions in the areas of social policies and capital spending, serious distortions would follow if they were excluded from the context of a fiscal projection. Consequently, Table A4.3 presents a projection including these funds, i.e., for the general government as a whole. Since the fiscal recording in China is particularly deficient as regards to the nature and size of the operations of these segments of general government, the basis for making a medium-term projection is–at best–incomplete. The projection presented here is based on a "mechanistic" assumption of unchanged activities relative to GDP.

The official policy is to reduce the scope of the extra-budgetary activities, by either curtailing or moving them on-budget. Thus, following a decision by the State Council, in 1997, 13 large EBFs (or fees) at the central level will be moved on-budget, with a corresponding increase of revenue and expenditure in the state budget of about 1.5 percent of GDP. Also, following a major investigation of the nature and size of the EBFs conducted during 1996, the authorities plan to impose strict limits on the operations of the local EBFs in the future. Consequently, the balance between the official budget and the EBFs will presumably change dramatically over the medium-term, with a marked decline in the size of extra-budgetary operations and presumably, a broadly corresponding increase in the volume of the recorded state budget. In the projection presented here, it is basically assumed that the present level of the fiscal activities conducted by these funds will be carried on, whether recorded on/or off-budget. This assumption may underestimate the potential efficiency gains and explicit expenditure cuts that may follow from the increased scrutiny of the funds' operations, presumably resulting from their move on-budget.

Under the assumptions made, the revenues and expenditures of the consolidated general government in the benchmark scenario will develop as illustrated in Table A4.3, with general revenues increasing from a current level of about 18 percent of GDP to 18.75 percent at the end of the projection period, and with expenditures declining by about 0.5 percent of GDP to 19 percent in

Table A4.3: Benchmark Projection - Consolidated General Government

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
State budget:																		
Revenue	**475.9**	**558.4**	**654**	**741.2**	**871.15**	**1015.74**	**1177.79**	**1369.27**	**1593.36**	**1856.62**	**2156.44**	**2501.58**	**2901.97**	**3364.49**	**3900.67**	**4522.26**	**5242.83**	**6078.15**
Expenditure	545.9	632.6	751.8	867.96	1000.25	1164.78	1345.79	1554 93	1782 54	2051 45	2360.88	2716.5	3126.66	3598.11	4140 58	4764.75	5482 92	630 24
Balance	-70	-74.2	-97 8	-126 76	-129.1	-149.05	-168	-185 65	-189.18	-194 83	-204 44	-215.37	-224 69	-233.62	-239 9	-242.49	-240 09	-231.09
Social funds: 1/																		
Revenue	63 82	70 2	73.71	85 78	99 56	115.04	132.91	153.57	177 43	205	236.86	273.67	316.2	365.34	422.11	487 71	563 5	651 06
Expenditure	57.91	63.7	66.89	77 84	90.35	104.38	120.61	139 35	161	186.02	214 93	248.33	286.92	331.51	383.03	442 55	511.32	590 78
Balance	5.91	6 5	6.82	7 94	9.22	10 65	12.31	14 22	16.43	18.98	21.93	25.34	29 28	33.83	39 03	45.16	52.18	60 28
Extra-budgetary funds:																		
Revenue	143.25	186.25	240	384 3	446.06	515.37	595 46	688	794.91	918.44	1061.17	1226.08	1416.61	1636.75	1891.1	2184.98	2542.52	2916 84
Expenditure	131.43	171.09	240	384 3	446.06	515.37	595 46	688	794.91	918.44	1061.17	1226.08	1416 61	1636.75	1891.1	2184.98	2542.52	2916.84
Budgetary	11.82	15.16	0	0	0	0	0	0	0	0								
Consolidated general government:																		
Revenue	682.97	814.85	967.71	1211.28	1416.77	1646 15	1906 16	2210.84	2565.71	2980.06	3454.47	4001.32	4634.78	5366.57	6213.88	7194.4	8330.85	9646 05
Expenditure	735.24	867.39	1058.69	1330.1	1536.66	1784 54	2061.86	2382.28	2738.46	3155.91	3636.98	4191.35	4830.19	5366.57	6414.7	7392.37	8518.77	9816.86
Balance	-52.27	-52.54	-90.98	-118.81	-119.88	-138.4	-155 7	-171 43	-172.75	-175.85	-182.51	-190.03	-195.42	-199.8	-200.82	-197.33	-187.92	-170 8
Ratios to GDP																		
State budget:																		
Revenue	13.74	11.98	11.23	10.93	11.07	11.17	11.21	11.28	11.36	11.46	11.52	11.56	11.61	11.65	11.69	11.73	11.77	11.81
Expenditure	15.76	13.57	12.9	12.8	12 71	12.81	12.81	12.81	12.71	12.66	12.61	12.56	12.51	12.46	12.41	12.36	12.31	12.26
Balance	-2.02	-1.59	-1.68	-1.87	-1 64	-1.64	-1.6	-1 53	-1.35	-1.2	-1.09	-1	-0 9	-0.81	-0.72	-0.63	-0.54	-0.45
Social budget:																		
Revenue	1 84																	
Expenditure	1.67																	
Balance	0 17																	
Extra-budgetary funds:																		
Revenue	4.14	3.99	4.12	5.67	5 67	5.67	5.67	5 67	5.67	5 67	5 67	5 67	5.67	5.67	5.67	5 67	5.67	5.67
Expenditure	3.79	3.67	4.12	5.67	5.67	5.67	5 67	5 67	5.67	5.67	5.67	5.67	5.67	5.67	5 67	5.67	5.67	5.67
Budgetary	0.34	0.33	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Consolidated general government:																		
Revenue	19.72	17.48	16.61	17.87	18	18.1	18.14	18.21	18.29	18.39	18.45	18.5	18.54	18.58	18.62	18.66	18.7	18.74
Expenditure	21.23	18.6	18.17	19.62	19.53	19.63	19.63	19.63	19.53	19.48	19.43	19.38	19.33	19.28	19.23	19.18	19.13	19.08
Balance	-1.51	-1.13	-1.56	-1.75	-1.52	-1.52	-1.48	-1 41	-1.23	-1.09	-0.97	-0.88	-0.78	-0.69	-0.6	-0.51	-0.42	-0.33

1/ Staff estimates Includes the pension funds, unemployment funds, medical fund, injury fund, and maternity fund.

the year 2010. This would imply a general government deficit of less than 0.5 percent of GDP, a decline of more than one percent of GDP from the present level.

Prospective Expenditure Demands

Consistent with officially stated policy objectives for the near- and medium-term, the budget will have to carry significant new expenditure programs. Little concrete information is available on the specificities of the nature, size or sequencing of these programs, and their fiscal implications can only be estimated as very rough orders of magnitude (see Table A4.4).

Physical Infrastructure

Significant infrastructure investment projects are planned in the areas of housing, roads and communications, agricultural improvements, energy and the environment. According to government estimates, the new highway construction program will cost approximately $150 billion over the next 15 years, of which approximately 20 percent is expected to be funded by the state budget, while the rest will be the responsibility of the provinces. It is uncertain to which extent this program will be implemented in its entirety, and with what burdens for the budget. Even larger construction projects are planned in the area of energy and power generation, to some extent with active government co-participation (through foreign loans guarantees or with the state budget directly assuming the debt burden), but in principle they are assumed to be self-financing over their economic lifetime. Because of the uncertainty relating to the possible budgetary burdens, the energy area has been held outside the projection presented here.[6] In the area of environmental improvement, significant prospective expenditure needs will have to be addressed according to official statements. The World Bank has estimated these needs to be about 0.2 percent of GDP over currently budgeted level. Concerning the totality of required infrastructure investments, in part assessed on the basis of the experiences of other developing countries, the World Bank has estimated that in order to sustain the present growth momentum and to avoid serious infrastructural bottlenecks, China would need to raise the investment ratio to about 7-8 percent of GDP.

Social Infrastructure

This heading covers a number of key expenditure areas where prospective demands will be significant if the momentum of economic growth is to be maintained with a minimum of social disruption. The associated future costs will depend on the policy decisions by the government concerning the design of a new social safety net system, the speed and strength of SOE reform measures, etc. In the area of pension reform, the World Bank has estimated that a move to a multi-pillar, partly funded pension system may entail transitory costs (present value of contingent liabilities during the phasing-out of the present pay-as-you-go system) of up to 50 percent of GDP, in addition to the costs of the new system. In the 1996 CEM, the Bank estimated the financing gap following the transition to the new system to slightly above one percent of GDP on an annual basis, to be covered in part by increased sales of state assets.

Table A4.4: Prospective Additional Budgetary Expenditures - General Government

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Physical infrastructure	...	...	...	...	...	45.46	63.06	84.97	112.19	145.83	187.22	237.94	299.91	375.39	467.09	578.23	668.08	771.9
Housing construction	...	...	...	...	...													
Roads and other infrastructure	...	...	...	...	...	20	23.11	26.7	30.85	35.65	41.19	47.59	54.98	63.53	73.4	84.81	97.99	113.21
Agriculture	...	...	...	...	...													
Energy	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Environment	...	...	...	...	...	18.18	21.01	24.28	28.05	32.41	37.44	43.26	49.98	57.75	66.73	77.1	89.08	102.92
Social infrastructure	...	...	...	...	...	99.92	193.71	316.69	457.19	625.46	778.82	964.74	1139.66	1345.64	1588.11	1834.9	2120.05	2449.51
Pension system	...	...	...	...	...	27.28	63.03	109.24	168.29	243.05	280.82	324.46	374.89	433.14	500.46	578.23	668.08	771.9
Extended coverage	...	...	...	...	...	18.18	42.02	72.83	112.19	162.04	187.22	216.31	249.92	288.76	333.64	385.48	445.39	514.6
Transition costs	...	...	...	...	...	9.09	21.01	36.41	56.1	81.02	93.61	108.15	124.96	144.38	166.82	192.74	222.69	257.3
Unemployment, reemployment	...	...	...	...	...	4.55	10.51	18.21	28.05	32.41	37.44	43.26	49.98	57.75	66.73	77.1	89.08	102.92
Other social safety net	...	...	...	...	...													
Poverty alleviation	...	...	...	...	29.15	40.82	57.14	80	92.56	106.94	123.56	142.76	164.95	190.58	220.2	254.42	293.96	339.64
SOE reform	...	...	...	...	...													
Health	...	...	...	...	...	18.18	42.02	72.83	112.19	162.04	224.66	302.83	349.89	404.27	467.09	539.68	623.54	720.44
Education	...	...	...	...	...	9.09	21.01	36.41	56.1	81.02	112.33	151.42	199.94	259.89	333.64	385.48	445.39	514.6
Financial infrastructure	...	...	...	...	...	9.09	21.01	36.41	56.1	81.02	93.61	108.15	124.96	144.38	166.82	192.74	222.69	257.3
Bank recapitalization	...	...	...	...	...	9.09	21.01	36.41	56.1	81.02	93.61	108.155	124.96	144.38	166.82	192.74	222.69	257.3
Total additional expenditures	...	...	...	...	...	154.47	277.76	438.07	625.48	852.31	1059.65	1310.84	1564.53	1865.41	2222.02	2605.87	3010.83	3478.71

Percent of GDP:	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Physical infrastructure	...	...	...	...	...	0.5	0.6	0.7	0.8	0.9	1	1.1	1.2	1.3	1.4	1.5	1.5	1.5
Housing construction	...	...	...	...	...													
Roads and other infrastructure	...	...	...	...	...	0.22	0.22	0.22	0.22	0.22	0.22	0.22	0.22	0.22	0.22	0.22	0.22	
Agriculture	...	...	...	...	...													
Energy	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Environment	...	...	...	...	...	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Social infrastructure	...	...	...	...	...	1.1	1.84	2.61	3.26	3.86	4.16	4.46	4.56	4.66	4.76	4.76	4.76	4.76
Pension system	...	...	...	...	...	0.3	0.6	0.9	1.2	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Extended coverage	...	...	...	...	...	0.2	0.4	0.6	0.8	1	1	1	1	1	1	1	1	1
Transition costs	...	...	...	...	...	0.1	0.2	0.3	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Unemployment, reemployment	...	...	...	...	...	0.05	0.1	0.15	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Other social safety net	...	...	...	...	...													
Poverty alleviation	...	...	...	...	...	0.45	0.54	0.66	0.66	0.66	0.66	0.66	0.66	0.66	0.66	0.66	0.66	0.66
SOE reform	...	...	...	...	...													
Health	...	...	...	...	...	0.2	0.4	0.6	0.8	1	1.2	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Education	...	...	...	...	...	0.1	0.2	0.3	0.4	0.5	0.6	0.7	0.8	0.9	1	1	1	1
Financial infrastructure	...	...	...	...	...	0.1	0.2	0.3	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Bank recapitalization	...	...	...	...	...	0.1	0.2	0.3	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Total additional expenditures	...	...	...	...	...	1.7	2.64	3.61	4.46	5.26	5.66	6.06	6.26	6.46	6.66	6.76	6.76	6.76

Table A4.5: Medium-Term Financing Gap - Consolidated General Government

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Billions of Yuan																		
Revenues, benchmark proj.	682.97	814.85	967.71	1211.28	1416.77	1646.15	1906.16	2210.84	2565.71	2980.06	3454.47	4001.32	4634.78	5366.57	6213.88	7194.94	8330.85	9646.05
Expenditure, total	735.24	867.39	1058.69	1330.1	1536.66	1939.02	2339.62	2820.35	3363.94	4008.22	4696.62	5502.19	6394.72	7431.78	8636.72	9988.15	11529.6	13295.6
Benchmark proj.	735.24	867.39	1058.69	1330.1	1536.66	1784.54	2061.86	2382.28	2738.46	3155.91	3636.98	4191.35	4830.19	5566.37	6414.7	7392.27	8518.77	9816.86
Additional exp.	...	...	...	...	...	154.47	277.76	438.07	625.48	852.31	1059.65	1310.84	1564.53	1865.41	2222.02	2605.87	3010.83	3478.71
Balance, financing gap	-52.27	-52.54	-90.98	-118.81	-119.88	-292.87	-433.45	-609.5	-798.23	-1028.16	-1242.16	-1500.87	-1759.94	-2065.2	-2422.84	-2803.21	-3198.74	-3649.51
Percent of GDP																		
Revenues, benchmark proj.	19.72	17.48	16.61	17.87	18	18.1	18.14	18.21	18.29	18.39	18.45	18.5	18.54	18.58	18.62	18.66	18.7	18.74
Expenditure, total	21.23	18.6	18.17	19.62	19.53	21.33	22.27	23.24	23.99	24.74	25.09	25.44	25.59	25.74	25.89	25.94	25.84	25.84
Benchmark proj.	21.23	18.6	18.17	19.62	19.53	19.63	19.63	19.63	19.53	19.48	19.43	19.38	19.33	19.28	19.23	19.18	19.13	19.18
Additional exp.	0	0	0	0	0	1.7	2.64	3.61	4.46	5.26	5.66	6.06	6.26	6.46	6.66	6.76	6.76	6.76
Balance, financing gap	-1.51	-1.13	-1.56	-1.75	-1.52	-3.22	-4.13	-5.02	-5.69	-6.35	-6.63	-6.94	-7.04	-7.15	-7.26	-7.27	-7.18	-7.09

Following reform of the SOE sector, substantial expenditure demands can be expected with regard to unemployment benefits and re-employment activities. Similarly, SOE reform measures per se may require budgetary resources, which are extremely difficult to project with a reasonable level of precision. The fight against poverty will, according to official policies, assume a very high priority in the medium-term. Related expenditures are projected by the Government to increase by about 40 percent per year, to reach about 100 billion Yuan in the year 2000. This estimate is used in the projection. Partly related to the problem of alleviating poverty, significant increases are planned for educational and health expenditures. To achieve universal access to good quality education and health services, the World Bank has estimated an additional annual expenditure requirement of about 2.3 percent of GDP.

Financial Infrastructure

Improving the soundness of the banking system will almost invariably lead to a demand for budgetary resources to clean up the portfolios of both the specialized banks and the policy banks. According to some reports, the authorities have already initiated this operation by increasing the reserves for bad debts linked to bankruptcies to 30 billion Yuan in 1997 (0.4 percent of GDP) from 20 billion Yuan last year, presumably in the context of the central budget. The present stock of bad debts in the banking system is considerable. The budgetary costs associated with such an operation will totally depend on how and how quickly it is executed.

The prospective expenditure demands associated with these programs are extremely difficult to project with a reasonable level of certainty. Consequently, the numbers presented in Table A4.4 should merely be considered as expressing technical working hypotheses. However, whatever the specific composition of the demands may be, their overall level is significant. Thus, a required lift of expenditures on the order of 5-8 percent of GDP does not seem implausible, resulting in financing of a closely similar magnitude at the end of the projection period, as shown in Table A4.5. Without adequate financing, such a gap would seriously threaten economic stabilization and revive inflationary pressures.

Financing Medium-Term Expenditure Demands

A financing gap of this size can only be met through fundamental changes in financing policies and tax structures, mainly through a combination of three sources: borrowing, sales/leasing of state assets ("privatization") or increased taxation. While the actual choice of balance between the three sources is a matter of political priority, it is assumed here that the tax-financing component will be dominant. While difficult to factor in, it is assumed here that improvements in tax administration will continue along the lines planned by the authorities, with the establishment of a modern and computerized administration during the projection period. Under that assumption, some combination of the following tax policy measures would be necessary to finance the required level of revenues.

- Scaling-back of tax concessions under the corporate income tax (CIT): gradually increasing the CIT rate in SEZs and other concession areas; unification of banking taxation of domestic and foreign banks; tightening tax holiday provisions; withholding taxes on dividend remittances (if tax treaty network allows it); repeal deductibility of financing of EBFs (if still present); repeal concessions on CIT liabilities to SOEs

(subsidies); introduction of standard accounting rules for calculating enterprise profits to avoid distortive taxation

- Broadening the base of the personal income tax: implement a phased reduction in the basic threshold; broadening of tax base by including self-employed and capital income, particularly interest income, dividend and capital gains
- Broadening the scope of payroll taxation to finance the expanded coverage of social safety net funds
- VAT: extending base to services; repeal exemptions and rebates; repeal lower rate
- "Normalize" the VAT (zerorating of exports, input credits on capital)
- Excises: increase excise on gasoline; increase excise on cars and other luxury items
- Other "green" excises
- Strengthening of land, property, and inheritance taxation
- Clarify taxation relations between levels of government: unify treatment of enterprises with different ownership forms; repeal exemptions granted by local governments; clarify tax sharing and transfer mechanisms

These measures will significantly improve the revenue buoyancy of the Chinese tax system and reduce present distortions.

ANNEX 5:
FURTHER STRENGTHENING THE MANAGEMENT OF EXTRA-BUDGET FUNDS –ANY LOCALITY, DEPARTMENT OR UNIT SHOULD NOT HAVE THEIR FISCAL REVENUE CONCEALED AND UNREPORTED

People's Daily. 6 August, 1996, Page 1

Xinhua News Agency, 5 August 1996: The State Council made a decision recently on strengthening the management of extra-budget funds. According to the information, since the reform and opening up policy was adopted, the extra-budget funds in our country increased rapidly, which played an active role in the economic construction and social welfare development. However, in recent years, some localities, at their own will, have transferred fiscal-budget funds to extra-budget funds through various kinds of illegal means, which was against the *Budget Law of the People's Republic of China* and the relevant regulations issued by the State Council. Some departments and units established their fund or fee programs at their own wish, which caused the loss of the state fiscal revenue and the continuous expansion of the extra-budget funds. At the same time, with the imperfect management system, the utilization of the extra-budget funds is not under the fiscal management and the supervision of the various levels of people's congresses. The problems of disorderly spending and over spending became severe. Those problems have not only caused the scattering of the state fiscal funds and the mass of the government public distribution order, but also expanded the fixed assets investment and the consumption funds, which contributed to the unhealthy tendencies and the corruption.

Therefore, the State Council asked, in the decision, that all localities, departments and units should strictly follow the *Budget Law of the People's Republic of China.* It is forbidden to transfer budget funds to the extra-budget. All levels of people's government should strengthen the management over the fiscal-budget funds and extra-budget funds, and perfect the supervision and checking system on fiscal funds. Any locality, department or unit should not have their fiscal revenue concealed and unreported and transfer the fiscal-budget funds to extra-budget funds. Without approval from the fiscal departments, all departments and units should not change their fiscal appropriations to compensatory utilization purposes at their will. They should not establish their extra accounts and "small exchequers (Xiao Jin Ku)", especially for the fiscal departments.

The State Council decided that from 1996, thirteen governmental funds (and fees) which are of relatively large volume should be transferred into the fiscal-budget management. Revenue from the funds (fees) should be delivered to the central treasury or local treasuries in time according to the current system. The line departments are responsible for putting forward the plans and the fiscal department shall make the appropriations according to the relevant regulations and rules. Should it be for capital construction purposes, the fiscal departments will arrange the expenditure according to the project plan approved by the planning departments. It should be managed with two separate streams of revenue and expenditure. The fiscal and audit supervision function should be strengthened. Revenue and expenditure of the funds (fees) should be listed separately in the budget and used as designated. Revenue and expenditure of the funds (fees) should not be used for other purposes, nor should the funds be used for the purpose of balancing the budget. The surcharges and fees collected by the local government in accordance

with the state regulations will be included in the local fiscal-budget as the fixed revenue of the local fiscal departments and no longer treated as extra-budget funds.

Based on the stipulations in the *General Financial Rules for Business Enterprises* and *Accounting Standards for Business Enterprises,* the retained funds after tax for the state owned enterprises should no longer be managed as extra-budget funds. Revenues from business and services through market by institutional organizations and social communities, which do not reflect the government functions, are not managed as extra-budget funds. Its revenue may be kept instead of delivered to the special account of fiscal departments, and is subject to tax according to the law, and shall be listed in the financial revenue and expenditure plan of the unit, and be put into the unified accounting for the revenue and expenditure.

The State Council asked in the decision to strengthen the management of fees and funds, and strictly control the scale of the extra-budget funds. Collection and withdrawing the extra-budget funds should be done according to the law, regulations and the items, scope, standard, and process that are defined by the legal regulations and rules.

Collection of fees for administration and undertaking development should strictly follow the management rules of getting the approval from both central and provincial government. Fee collections should be, according to the subordinating relations, respectively reported to and be approved by the State Council or the fiscal department and the planing (price) department of the peoples' government of provinces, autonomous regions and municipalities. When defining and adjusting the fee collection standards, it should be reported to and approved by the State Council or the planning (prices) department and the fiscal department of the peoples' government of provinces, autonomous region and municipalities. The State Council or people's governments of provincial level should approve import fee collections and the standard formulation as well as the adjustment. Fee collections for administrative undertakings and the collection standards approved by provinces, autonomous regions and municipalities should be reported to the MOF and the SPC for record. All levels of people's governments under provinces, autonomous regions and municipalities (including cities directly under the state budget) and their departments have no right to approve the establishment of the administrative undertaking fees or adjustment of the collection standard. Central government will approve the managerial fees in the administrative fees, fees related to the resources, national license fees and public undertaking fees. Collections of various kinds of administrative undertakings, as well as the local fees related to the central government and other localities that have not been reported and approved, or are not in accordance with the regulations, are categorized arbitrarily as collecting fees and must be terminated.

Government fund collections should strictly follow the regulations defined by the State Council and should be reported to and approved by MOF. The important ones should be reported to and approved by the State Council. Application and approval of setting up the funds should be made in accordance with the state laws and regulations and the regulations cited in the relevant documentation of the central government and the State Council. Otherwise it is not allowed. Local governments have no right to approve the setting up of funds projects, nor to approve, in other forms, the setting up of funds in the name of the administrative undertaking collections.

The State Council stressed in the decision that the extra-budget funds are from state fiscal funds. They are not the self-possessed funds of the departments and units. They must be put into

fiscal management. Fiscal departments should open a unified special account in banks for the management of revenue and expenditures of the extra-budget funds. Revenue from extra-budgets of the departments and units must be delivered to the fiscal special accounts of the same level. Expenditures shall be arranged by the same level of fiscal department according to revenue and expenditures of the extra-budget funds plan and the units financial revenue and expenditure plan, and be allocated from the special fiscal accounts, thus to realize the management of the two separate streams of revenue and expenditures.

Fiscal departments should establish a management system for the auditing of the extra-budget funds. All departments and all units should compose, according to the regulations, their revenue and expenditure plan of the extra-budget funds and report to the same level of fiscal department, thus to have a unified accounting and unified management of the budgetary appropriation and extra-budgetary revenue.

The extra-budget expenditure should be managed carefully. It is forbidden to use it against the regulations. All departments and units should strictly follow the state regulations and revenue and expenditure plans of the extra-budget funds defined by the fiscal departments as well as the revenue and expenditures in the unit financial plans when using the extra-budget funds. Funds and fees targeted for public utilities and public undertakings and other special funds should be earmarked for special purposes according to the plans and regulated usage. They should be checked by the fiscal departments and allocated by installments. Expenditures for paying wages, bonuses, subsidies, allowances and welfare should be made strictly in accordance with the items, scopes and standards defined by the fiscal departments. When making expenditures for the fixed assets investments, the projects should be made in accordance with the state regulations and put into state plans for the fixed assets investments. The expenditures should be made by installments according to the state investment plans and projects' schedules defined by the planning departments. Expenditures for purchasing the specially controlled goods need to be reported to and approved by fiscal departments. Then there is a need of going through formalities for the controlled purchase approval according to the state regulations. It is forbidden to transfer the extra-budget funds to non-financial institutions to manage, set up extra accounts, set up small exchequers or deposit public funds as private ones. It is forbidden to use extra- budget funds for investment in real estate etc., for trading activities in stocks and dealing in futures, as well as various kinds of high level consumption. Fiscal departments should take responsibility to establish and improve various kinds of management systems and actively provide services. They should appropriate extra-budget funds in time and strengthen the management of extra-budget funds.

The State Councils, in the decision, also required localities and departments to establish and improve their supervision and penalty system. All levels of people's governments should receive supervision of their same level of people's congresses on the utilization of the extra-budget funds. All levels of fiscal departments should strengthen the management of the revenue and expenditure of the extra-budget funds, establish and improve their inspection system for various kinds of fees and funds, and, together with the PBC, manage well the establishment and management of the accounts of the extra-budget funds. Those who are against the regulation of the extra-budget funds management shall be penalized according to the state laws and regulations.

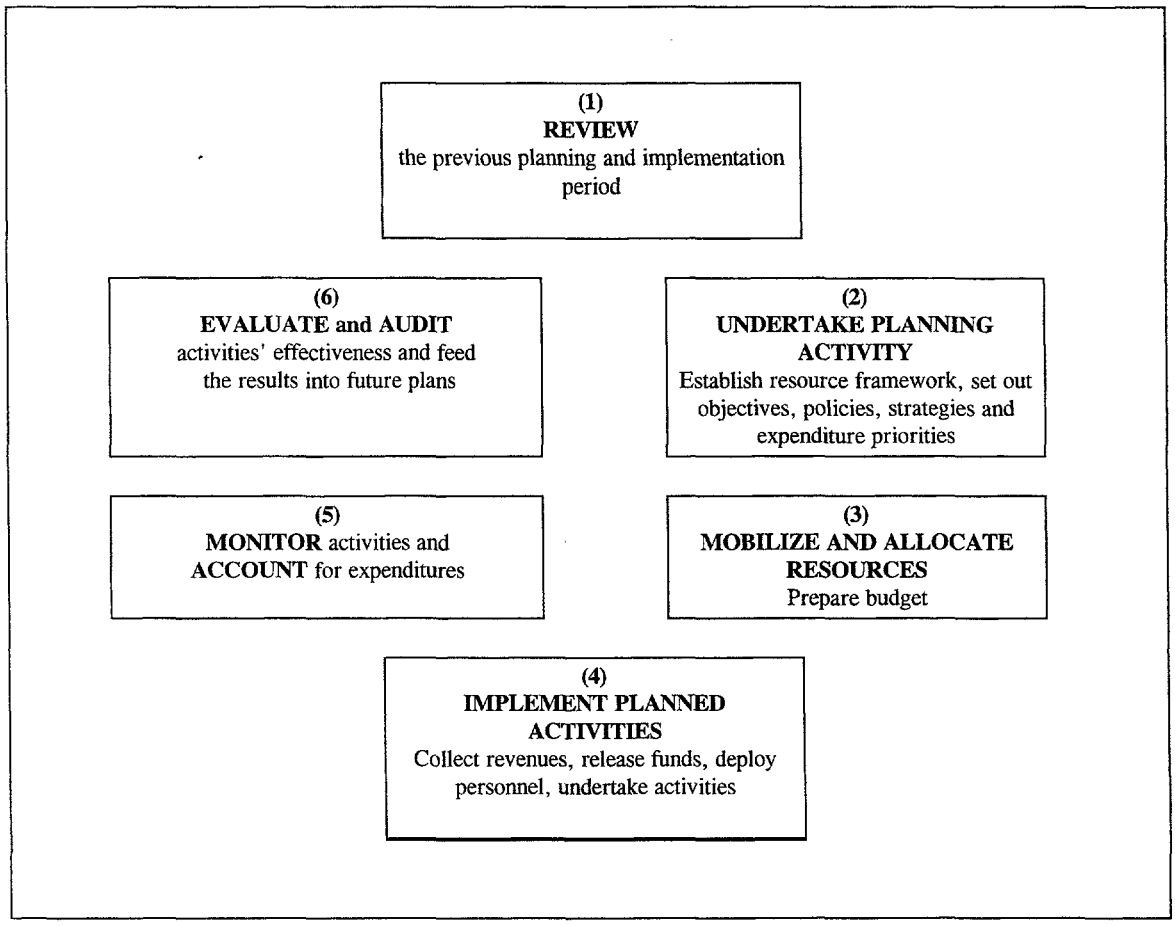
All levels of government should pay attention and strengthen the management of the extra-budget funds. Efforts should be made to clear and rectify the extra-budget funds. If the

funds are in the category of budget management that are stipulated by the state, they should be included in the budget. If the fees and funds are found to be set up against the state regulations they should be abolished.

ANNEX 6:
LINKING PLANNING, POLICY AND BUDGETING IN A MEDIUM-TERM FRAMEWORK

Fiscal crisis, importantly reflecting inadequate links between planning, policy and budgeting, was the genesis of much of the radical restructuring of decision making and budget practice in most OECD countries over the past 15-20 years. It is arguable that the same inadequacies may be the single most important factor contributing to poor budgeting outcomes at the macro, strategic and operational levels in developing countries and economies in transition. The response in OECD countries and in an increasing number of developing countries has been to focus more on a top down approach to budgeting, which acknowledges budget realities at the outset, and to set decision making in a more medium-term framework. Recognizing the tremendous pressures on its budget, China has taken the first tentative steps in developing a more medium-term perspective to its budgeting. This note provides guidance on approaches to improving these linkages throughout the full cycle of planning, policy and budgeting (Figure A6.1). It concludes with an outline of the Australian medium-term expenditure framework (MTEF).

Figure A6.1: Linking Planning Policy and Budgeting



Integrated planning, policy and budgeting is fundamentally about having expenditure programs that are driven by policy priorities and disciplined by budget realities. The challenge is to manage the tension between "needs" and "availabilities" more effectively (Box A6.1). A medium-term approach provides a linking framework and facilitates the management of the tension between policy and budget realities to reduce pressure throughout the whole budget cycle. The result is better control of public expenditures and better value for money within a hard but predictable budget constraint.

Linking planning, policy and budgeting can be accomplished progressively at a pace that fits a country's capacities. The sector is one level at which the process can begin. Many of the potential gains at this level, however, will not be realized if the central planning, resource allocation and budgeting system does not change to support a better balance between policies and resources at the sector level. It will be important to begin to move quickly to implementing a medium-term perspective to central resource allocation and budgeting in order to provide a context for the sector and a government-wide mechanism that forces politicians to confront trade-offs between sectors and policies at a strategic level. Whatever the form of MTEF, it will take a number of years to develop, as it will need to encompass all expenditures and have the following elements:

Box A6.1: Needs Versus Availability

In many countries, budgeting has been undermined by the "needs" rather than "availability" psychology of the budget actors. While finance ministries stress "availability" (the revenues expected to be forthcoming from domestic and external sources), line ministries persist in basing budget proposals on "needs." The result is a negative-sum budget process that undermines macro-economic stability and program and project effectiveness.

These conflicting perspectives are understandable. The finance ministry is constantly battling weak domestic revenues, the debt servicing burden and mounting claims on-budget resources. Since it has responsibility for the macro-economic consequences of fiscal deficits, the MOF has no alternative but to preach the "availability" message through tight budget ceilings. If a satisfactory budget cannot be prepared, it remakes the budget during implementation through the release-of-funds mechanism, at a high cost to project and program efficiency. Line ministries inherit commitments they lack the resources to meet, yet must daily confront the consequences of inadequate allocations. Population growth, the running costs of newly-completed projects, and unforeseen crises further pressure slender budgets. Budget bids are submitted two to three times over finance ministry ceilings. When requested to concentrate resources on priority programs, departments answer they have no mandate to cut service. Privately, they fear that to submit a lower bid within the ceiling would make them vulnerable to further cuts. The debate about "needs" makes no connection with using existing program allocations more efficiently.

In countries where the gap between commitments and resources is so large, a satisfactory reduction is unlikely to come about within the tight perspective of the annual budget. A more fundamental public expenditure planning process has to take place engaging finance, planning and line ministries and Cabinet (because inter-sectoral trade-offs have to be faced) in a process that has a medium-term perspective. Donors, too, need to be involved because of their heavy contribution to budget financing. "Availability", both domestic and aid, must be projected beyond a single year and indicative shares communicated to departments. "Needs" must be prioritized and made consistent with the resource framework. All this must happen in a manner that encourages departments to re-examine commitments and their resourcing with central ministries in a more cooperative framework.

- aggregate fiscal targets
- forward estimates of the cost of existing policy
- institutional mechanisms for making the trade-offs between "availabilities" and "needs" in such a way that performance is improved at the macro, strategic and operational level
- enhanced predictability.

Sector Level Planning, Policy and Budgeting

Years of short-term planning for annual budgets and hand-to-mouth adjustments during the budget year have led to accumulated overcommitments and inefficiencies at the operational level. The requirement now is to create enough certainty so that line ministries and agencies can plan ahead, have the incentives to do so and have better information on which to base strategic and operational decisions. This requires the development of a comprehensive MTEF. However, integrating planning, policy and budgeting at the sectoral level will provide the building blocks for such a system.

The focus should be on the whole sector–a coherent set of policies, programs and activities that need to be looked at together. The objective must be to have a balance between policy and resources, both in the short run and over the medium-term.

An early question is whether government has a policy responsibility at all or whether policy should be left to the private sector and/or civil society. Having decided that there is a policy issue for government and that the appropriate instrument is the budget, the possible expenditure implications of the policy issue need to be assessed. A strategic issue that will then need to be confronted is the role of cost recovery in pursuing the policy objective within a constrained budget.

The assessment might reveal inconsistencies between declared priorities and actual expenditures. Ideally, decisions should be based on the relationships between input costs, outputs and outcomes. In practice, even basic information on the costs of inputs is often lacking. In most countries, little attention has been given to measuring outputs and outcomes. Poor information makes it impossible to evaluate cost-effectiveness. A good starting point would be to work out what existing activities would cost if fully funded, i.e., if facilities were adequately maintained, if staff were paid a reasonable minimum salary and if essential complementary inputs were provided to help determine whether government is attempting more than it can afford.

Mechanisms must be in place to facilitate a shift in resources from lower to higher priorities. This means considering elimination of whole programs and activities as well as making "policy" adjustments, e.g. higher pupil teacher ratios.

Medium-Term Expenditure Framework

An MTEF is a centrally-driven strategic policy and expenditure framework within which ministers and line ministries are provided with greater responsibility for resource allocation decisions and results. The key to a successful MTEF is that institutional mechanisms exist which assist and require relevant decision makers to balance what is affordable in aggregate and the policy priorities of the country. It consists of a top-down resource envelope, a bottom-up estimation of the current- and medium-term costs of existing policy and, ultimately, the matching of these costs with available resources. The latter should normally occur in the context of the annual budget process, which should focus on the need for policy change to reflect changing macro-economic conditions as well as changes in strategic priorities of the government. Conservatively, defining medium-term resource envelopes for departments should help change the psychology of budgeting from a "needs" to an "availability" mentality. An MTEF is particularly relevant to countries that need to restructure public expenditures and aims to:

- improve macro-economic balance by developing a consistent and realistic resource framework;
- improve the allocation of resources to strategic priorities between and within sectors;
- increase commitment to predictability of both policy and funding so that ministries can plan ahead and programs can be sustained;
- provide line agencies with a hard budget constraint and increased autonomy, increasing incentives for efficient and effective use of funds.

Macro-Analysis and Modeling

Linking economic projections to fiscal targets. The transition from planning to budgeting often suffers from inconsistencies such as overcommitment. This occurs when decisions do not take into consideration opportunity costs and knock-on effects. Models can assist in identifying problems by checking the internal consistency of proposals and by generating accurate forecasts. Models can also illustrate the trade-off between alternative uses of resources and can make explicit the underlying assumptions about relationships and priorities. Constructing a model can expose differences in assumptions about what drives decisions or relationships and reveals deficiencies in data. Personal computers and software have increased the scope for using models for analysis and explanation.

Constructing and using models. The value of model building stems from involving the interested parties in reviewing data, discussing different perceptions about the relevant relationships and identifying data requirements.

Strategic Framework

A high-level consensus is essential to ensure discipline in adhering to expenditure targets and to the agreed procedures for adjusting them. The consensus needs to include political and technical levels and to cover:

- broad objectives of policy and the role of government in the economy,
- the need for discipline in macroeconomic management,

- targets for broad aggregates of public revenue and expenditure, and
- procedures for setting and revising the expenditure framework and the responsibilities of key agencies.

Procedures. The sequence in which the cabinet considers expenditures is important. Decisions on aggregate expenditures and revenue targets and on broad principles of government policy should precede the consideration of detailed expenditure proposals. Forward projections should be prepared at the policy and program level and should be reviewed before the next annual budget is considered in detail. Once high levels agree upon any changes in key policies and broad allocations, lower levels can be entrusted with the details.

Appropriate intervals must separate the stages. Line agencies should receive broad guidelines in time to reflect them in their proposals, otherwise strategic issues are set aside in the rush to complete the detailed annual budget.

The central agencies need to prepare the initial framework paper, which would review the economic and fiscal situation and prospects, propose aggregate fiscal targets for the planning/budget period, identify key strategic and policy issues and propose sector allocations for line agencies to use in framing their own proposals. Coordination is needed where responsibilities are divided between finance and planning ministries to generate joint submission to the Cabinet at the beginning of the cycle and to collaborate in the review of line agency proposals.

All parties need to understand the need for: (a) persistence through successive annual cycles, and (b) a strengthening of the financial administration and information systems and (c) parallel efforts to strengthen macro and sector analysis.

Strategic Allocation

Sector resource envelopes. Top-down sector resource envelopes with a medium-term horizon are a basis for predictability so that appropriate strategic and efficient operational decisions can be made. Establishing a sustainable macro ceiling for government expenditures over the medium-term, then breaking it down can derive sector resource envelopes. A division between discretionary and non-discretionary expenditures should be made. What is non-discretionary is often exaggerated. A medium-term perspective increases the scope of effective discretion, e.g. over staffing levels and salary obligations. An unallocated contingency can be withheld to cope with uncertainties and to allow for adjustments for unanticipated expenditures, but this should be kept to a minimum, as it can easily become a "slush" fund.

The political nature of resource allocations makes it wise to reach agreement on the criteria to be applied to allocations. Agreement on criteria provides guidance on how to adjust to new or altered circumstances and can increase discipline and predictability. It is also important to have reliable and timely estimates of the costs of current government policies because, in aggregate, they indicate the nature and extent of the pressure on the budget and signal the costs of all the previous decisions made by government. Their value to government decision making will depend on their reliability in each of the forward years.

The following can contribute to the setting of broad allocations:

- identifying whole categories of public expenditures that should be phased out;
- analyzing the functional classification of expenditures to identify inconsistencies between actual allocations and roles for the public sector;
- checking international comparisons for expenditure ratios for each sector;
- analyzing underfunding/overcommitment, including composition of expenditures, e.g., the balance between personnel and operating expenditures, trends in real levels of salaries and of aggregate funding, and the extent to which the investment budget has become a disguised vehicle for recurrent expenditures;
- considering cost recovery;
- reviewing recurrent cost implications of capital expenditures; and
- looking for explicit or implied expenditure commitments not already factored into projections.

Sector envelopes reflect both the inertia associated with existing policy and the dynamic of the changing priorities of government–political, economic and social. The envelopes should be defined in a way that provides incentives for trade-offs between policies and programs at the sector level. Aid and local funding, and capital and recurrent expenditures should be incorporated within a single guideline. This comprehensive approach should result in pressure to unify the budget and to reduce bias in the choice between investment and recurrent expenditures. This comprehensive approach will take time to implement.

The Stages of the MTEF

Thus, the stages in preparing an MTEF include:

a. developing a consistent macro-economic framework and, from this, realistic resource projections for three years;

b. deducting statutory payments such as pensions and debt payments;

c. breaking down the remaining aggregate expenditure figures into sectoral ceilings, based on the relative importance of each sector;

d. providing line agencies with ceilings for the budget year, together with indicative ceilings for the two outer years;

e. determining for each sector which programs should receive a greater or lesser share of the sector resource envelope (ministries need to determine the actual costs of these activities before they can make realistic and rational decisions about the allocation of resources);

f. approval by Cabinet of the annual budget;

g. preparation of annual budget estimates (year one of the MTEF); and

h. approval of the budget by Parliament.

Factors that determine the success or failure of an MTEF include:

- political commitment and endorsement at the highest level to make and abide by the difficult decisions involved in the restructuring of expenditures (some ministries may need to scale back their activities so that more resources can be directed to higher priority sectors);
- understanding of, and commitment to, the difficult decisions at the sector ministry level;
- commitment at all levels to abide by the budget decision so that new expenditure decisions are not introduced during budget implementation that would require reallocation of resources (these new decisions mean that the priorities set when the budget is approved by Parliament are often overturned);
- improvements in expenditure control so that the decisions are not undermined by overexpenditures and reallocation of funds during budget implementation;
- improved macroeconomic management and revenue collection so that revenue shortfalls do not necessitate adjustments to the budget estimates;
- briefings of politicians and senior management during implementation;
- improvements to expenditure reporting on results; and
- development of a computerized accounting system.

The MTEF provides a framework within which strategic sector reviews should be undertaken (Box A6.2). This takes us a full circle back to the comment at the beginning of this note about the importance of setting the linkage of planning, policy and budgeting within the context of an MTEF.

The development of an MTEF is very much an iterative process, as is the annual budget process once an MTEF is in place. Stage 1 involves developing the expenditure framework, taking account of resource availability, the role of government and priorities between sectors (the iterative nature of the process is highlighted here, as establishing priorities between sectors requires the information generated by stage 2).

Stage 2 involves the sector review process, through which each sector (including all ministries and institutions) would define objectives, policies and strategies, together with the costs of current and proposed sector policies over the medium-term. These would need to be sufficiently clear so as to enable the ministries and institutions to define the functions and activities involved in implementing the agreed strategies.

Stage 3 involves identifying structures and personnel required, the recurrent and capital costs of implementing the activities, and the projects associated with these costs.

Stage 4 involves monitoring staff performance, costs and program performance.

Box A6.2: An Integrated Strategic Planning Process

STAGE 1:
Medium-Term Expenditure Framework
Macroeconomic Framework
Resource Framework
Role of Government
Sectoral Ceilings

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STAGE 2:
Strategic Sector
Objectives, Policies, and Strategies
Functions and Activities

↓

STAGE 3:

Ministry Structures	Expenditure Requirements	
Personnel Requirements	Recurrent Costs	Capital Costs
	Project Costs	
	↓ **STAGE 4:**	
	Monitoring Information	
Personnel Performance Monitoring	Accounting Information	Performance Indicators

ANNEX 7:
THE AUSTRALIAN EXPERIENCE WITH A MEDIUM-TERM EXPENDITURE FRAMEWORK

When Australia embarked on its comprehensive reform program in the early 1980s, a key consideration was the perceived inadequacies in the links between policies and programs and the resources allocated to their implementation. Fiscal crisis subsequently raised fundamental concerns about the affordability of current government policies. The response to this was to take the system of forward estimates that had played a peripheral role in decision making and place it at the center of both resource allocation decision making and resource use.

Aggregate Fiscal Targets

Beginning in 1985, the central government adopted a medium-term "trilogy" strategy of not increasing outlays or revenue as a proportion of GDP and of reducing the deficit/GDP ratio. Subsequent economic crisis saw this commitment tightened to no real increase in expenditures. The credibility of the forward estimates discussed in the next section was central to the success of this strategy. The end of the 1980s had been converted to the deficit of 4 percent a surplus of 2 percent; government had significantly reoriented expenditures to reflect its core strategic priorities and the incentives for efficient and effective use of resources had been considerably strengthened.

Recession in the early 1990s saw a return to deficits and fiscal targets have been focused on a realistic time path for returning to balance (the 1997-98 budget deficit is forecast to be less than one percent). More significantly has been the "Budget Honesty" commitment of the government that requires the government to regularly publish projections of expenditure and revenue, notably in the three months prior to an election. (The New Zealand Fiscal Responsibility Act goes even further by committing government to make public its long-term fiscal objectives and to pursue policies which are consistent with maintaining crown debt at a prudent level and with a reasonable degree of predictability about the level and stability of tax rates in future years.)

Forward Estimates of the Cost of Existing Policy

The "forward estimates" system evolved in Australia in the late 1970s through the 1980s. The forward estimate process develops estimates that, on a rolling basis, project the level and composition of expenditures for three years beyond the current fiscal year, assuming no policy changes. These are adjusted requlary to take account of factors such as inflation, where program expenditures are indexed, and government policy decisions that may increase or decrease estimated costs.

The practice prior to 1983-84 involved the Department of Finance collecting bids for program spending from sponsor departments without rigorously examining the basis for them, except with respect to the first year. Accordingly, these bids reflected departments' own assessments of their future needs, a practice described by M. Keating and M. Holmes (1990) as "a major cause of creeping incrementalism of government [expenditures]."

Under the new approach, the Department of Finance negotiated with departments the estimates for existing programs and then assumed responsibility for updating the forward estimates at regular intervals to reflect, as indicated above, changes in economic parameters, other technical variations and, most importantly, the effects of government policy decisions. The same process is followed with new policy and program proposals, for which projected costs for the full forward estimates period are required as part of the policy proposal considered by Cabinet. Thus, the Department of Finance is seen as "owning" the forward estimates.

Furthermore, whereas previously there tended to be widespread annual renegotiation of estimated expenditures, the new system is much more policy focussed, involving ministers primarily in the relatively small percentage of budgetary matters that require policy or strategic decisions (although the funding implications may involve a high proportion of budget funding). Thus, the forward estimates are a disciplining mechanism in the budgeting process that enables a greater focus on strategic policy issues. At the same time, they provide much greater predictability as to resource levels for departments and agencies. In essence, the system envisages that if government policy does not change then funding will be provided in accordance with the forward estimates.

One senior offical has attested to the significant impact of forward estimates as follows:

> The fact that we now have a budget system in place with forward estimates and that the haggle over the base for each new budget year does not take place any more is a huge advance. If you had to pick out the one thing that we have done above all others, this reform would be the most dramatic change.

In 1983, a significant decision in the evolution of the forward estimates system was made when the government decided to publish them. The requirement to disclose costs for the three-year forward period was intended to ensure that decisions were made with greater awareness of future commitments and to provide Parliament and the public with better information about budgetary realities and public expenditure patterns and priorities. The decision to publish also meant that forward estimates had to be taken more seriously, thus leading to their progressive upgrading (M. Keating, M. Holmes 1990).

As the system has evolved, the government is required to disclose and justify the costs of policy decisions leading to discretionary changes in expenditures over the three-year forward estimate period. The estimates are published in the budget alongside the budget year figures and changes between the forward years and the budget are reconciled in budget documents–that is, the budget estimates are reconciled with the forward estimates compiled the previous year. These reforms have tended to shift the focus for ministers and senior officials to a medium-term period (of four years), rather than the current budget year.

The impact of the forward estimates has been such that an evaluation of government reforms in 1993, in linking the forward estimates system to the record of overall government spending restraint, characterized them as central to the expenditure control process." More recently, a former official who had been instrumental in the development of the government's budgetary and financial management reforms of 1980s stated:

The forward estimate process and system was so central because it provided the backbone which linked the Expenditure Review Committee's (see below) macro-economic and strategic policy-making, portfolio budgeting and the running costs system [the latter is discussed in a separate note]. It has provided a framework for a more strategic approach to decision making, much greater predictability in funding for current policies and for removing from the budgetary arena those decisions best made elsewhere (most notably management decisions). The system has built on trust and has changed behavior fundamentally. Perhaps the most important factor here has been the fact that, having changed the formal rules, all the players have played by the new rules (1996 interview).

Institutional Mechanisms for Making the Trade-off

There can be little doubt that the Expenditure Review Committee (ERC) established by the Labor Government in the mid-1980s was central to the subsequent improvements in all three levels of budgetary outcomes. This committee was a sub-committee of the Cabinet, consisting not only of the Prime Minister, the Treasurer and Minister of Finance but also of a number of other senior "spending" ministers. This committee was responsible for determining the overall fiscal framework and for managing strategic policy making, including policy changes necessary to reflect fiscal realities as well as the shifting priorities of the government.

One of the key strategic decisions made by the ERC was the resource envelope for each sectoral minister for finalization of the annual budget. Depending on whether the envelope was higher or lower than the forward estimates of existing policy (adjusted for the individual policy decisions made by ERC - see previous paragraph), individual sector ministers would have to seek programmatic changes that would produce savings or they may be able to introduce new initiatives. The key point here is that it was left to sector ministers to determine the best allocation of resources to policies and programs in their sector consistent with overall government policy and within a hard budget constraint.

The third element of the system was the running costs system. This system, which is discussed in some detail in a separate annex, provides line managers with considerable flexibility in managing their personnel and administrative resources within a hard budget constraint but one that is predictable over the medium term. This system has eliminated the annual haggle over funding levels for administration and has meant that ministers have been freed from involvement in decisions at this level. It is the efficiency dividend component of the system that has enabled decisions on running costs to be kept out of the Cabinet arena and has built the trust between line agencies and the MOF.

Finally, it is worth noting that the forward-estimates system has enabled the MOF to assume something of a banker role. This can be illustrated by reference to the example of the major modernization of the Australian tax system. This involved an investment of over A$1billion. Because of the forward estimates, MOF was able to reduce the Tax Office's running costs in the outyears for the savings generated by the investment. The benefits from this are obvious, not least in the changed incentives on line agencies to have sound analysis of expenditure proposals.

ANNEX 8:
THE RUNNING COST SYSTEM IN AUSTRALIA

The Running Cost System is an integral part of the broader Public Expenditure Management System, which is designed to provide managers with:

a) Substantial flexibility in the use of budgeted running costs and greater predictability over resource levels beyond the budget year; and
b) A strategic framework, with associated evaluation and reporting requirements, which encourages and requires managers to focus on results and the resources required to achieve them.

The objective of the running cost arrangements is to improve the efficiency and effectiveness of resource use in the public sector. The arrangements were introduced in 1987-88 as part of the Central government's Financial Management Improvement Program. The arrangements:

- Provide managers with increased authority and responsibility for the use of resources;
- Provide incentives to agencies to improve public sector efficiency and effectiveness by allowing them to retain the majority of savings arising from increased efficiency;
- Restrain costs growth through cash limiting and restricting access to supplementation; and
- Make efficiency gains visible by applying an annual efficiency dividend.

Definition of Arrangements

The running cost of an agency represent the full recurrent costs, and minor capital costs, consumed by an agency in providing the Government services for which it is responsible.

- These include salaries and related employment costs, superannuation, administrative items, minor capital items, property operating expenses and the purchase of goods and services from the private sector including consultancy services, research, advertising and public relations services.
- These exclude all transfer payments (pensions, grants, subsidies), major capital payments and loans.

The running cost arrangements are a set of rules and procedures, which enable agencies to make most efficient use of the resources available for running cost. The running cost arrangements apply to budget funded agencies operating on the Commonwealth Public Account.

Legislative framework

The Constitution provides that funds may not be spent unless appropriated by Parliament. The running cost arrangements are therefore implemented within the legislative framework of the Commonwealth Budget.

The running cost budgets of agencies subject to the running cost arrangements include funding from:

- Parliamentary appropriations:
  - included in the *Appropriation Act (No. 1)* and Supplementary Appropriations (Additional Estimates) or equivalent appropriation Acts for the parliamentary Departments; and
- Retention of receipts through section 35(3) of the *Audit Act 1901* (see below).

Notional Items

A notional item sets a maximum limit on the amount that can be spent on a component within the appropriation. From 1995-96 there are two notional items for each functional classification within the running cost appropriations for most agencies:

- Senior Executive Service (SES) Salaries; and
- Other Running Costs (i.e. including all non-SES salaries).

Running Costs Flexibility

Under this structure, agencies have full flexibility to shift resources within other running cost to meet competing priorities without needing to seek the agreement of the Department of Finance. The notional items are the only points of control on expenditures within the total cash limited running cost budgets.

Transfers between running cost and non-running cost appropriations require the approval of the Secretary of the Department of Finance.

Cash Limiting

Annual running cost budgets are cash limited.

- The onus is placed on agencies to manage within the confines of a set running cost budget.
- Agencies must absorb the entire running cost associated with new policy decisions outside the budget context.

Costing of variations to running cost estimates will generally not be reopened for further consideration except by reference to the Cabinet in the new policy context of the annual budget. Agencies must absorb all or part of any increase in running cost sought for new policy except when the total portfolio new policy is fully offset by agreed savings in program or running cost or by agreed revenue increases. The amount to be absorbed is equivalent to one percent of the existing running cost base of the agency before the addition of new policy, savings and one-off adjustments.

Price Adjustment

Administrative Expenses and Property Operating Expenses

These items are indexed annually by different deflators–administrative expenses (including legal services) are indexed by the Commonwealth Final Government Consumption Expenditure deflator; and property operating expenses are indexed by the Running Costs Property Index .

Indexation is finalized prior to each budget. Each item is indexed by the latest available deflator outcome, that is the actual price movements for the previous calendar year. This replaces the previous arrangements where items were indexed to forecast changes and subject to ex-post price adjustment.

Agencies now have funding certainty from the commencement of the financial year and are able to plan accordingly.

Salary Supplementation

If Cabinet approves Supplementation, SES and non-SES salary estimates are supplemented for award increases and other approved wage and salary related decisions.

Efficiency Dividend

The efficiency dividend was introduced in 1987-88 as an integral component of the running cost arrangements. All agencies must pay the efficiency dividend unless specifically exempted by Cabinet. The efficiency dividend aims to:

- Provide managers with the incentive to continually seek new or more efficient means of undertaking ongoing government business;
- Allow government to redirect a portion of efficiency gains to higher priority activities; and
- Clearly demonstrate Public Service efficiencies resulting from improvements in management and administrative practices.

Statutory bodies not operating on the public account are also required to pay an efficiency dividend, unless specifically exempted.

The current efficiency dividend rate applying to running cost agencies is one percent per annum (previously 1.25 percent). This is applied to the total net running cost (i.e. excludes receipts through section 35 net annotated appropriations).

The efficiency dividend is applied before the running cost base is indexed to budget year prices and before any other one-off ongoing adjustments are made.

Resource Agreements

A resource agreement between an agency and the Department of Finance is an agreement for the provision of resources in return for some action, undertaking to act, or some other consideration. It provides the agency with additional resourcing flexibility outside the confines of the regular budget process in order to achieve some stated objective.

Common types of agreements include:

- Receipts retention and sharing (including section 35 agreements);
- Multiple year carryovers and borrowings;
- Carryovers of greater than 10 percent and borrowings of greater than 6 percent;
- Workload adjustment formulae;
- Property resource agreements; and
- Workplace bargaining agreements.

Carryovers

Carryovers are the mechanism by which resources appropriated in one year can be spent in some future years. Carryovers:

- Provide agencies with the flexibility to respond to changing spending priorities;
- Reduce the incentive for unnecessary end-of-year spending by agencies; and
- Allow managers to plan spending without being restricted by cut-off dates.

Up to 10 percent of the total running cost budget (including section 35 annotated appropriations) can be carried forward from any one year.

Multiple Year Carryovers

A multiple-year carryover is a carry forward of funds over at least two years where the funds carried over are not used in the intervening year or years. Multiple-year carryovers are subject to a resource agreement. The resource agreement should state:

- The specific purpose for accumulating funds;
- The interest rate to be applied (currently 8 percent per annum); and
- When the funds are expected to be required.

Interest is payable on multiple-year carryovers which are negotiated in advance with the Department of Finance. Interest is paid initially at the budget following the end of the financial year from which the carryover was made. Interest is then paid at every following budget (i.e. in May after previous June end of financial year) on the cumulative carryover amount for each year the carryover is maintained.

Borrowings

Borrowings allow agencies to bring forward some future years' appropriation to be spent in an earlier year. This provides agencies with:

- The flexibility to respond to changing spending priorities; and
- A mechanism to meet unforeseen costs.

Borrowings can be arranged either:

- Through annual appropriation or additional estimates bills, with a consequent reduction in a future appropriation; or
- Through the Provision for Running Cost Borrowings where the borrowing does not coincide with an appropriation bill.

Agencies are allowed to borrow up to 10 percent of the total running cost budgets (including section 35 receipts) from any one year.

- Borrowings of greater than 6 percent are allowed provided a resource agreement is signed.
- Borrowings of over 10 percent are allowed only in exceptional circumstances.

Multiple-Year Borrowings

Borrowing running cost over multiple years is allowed provided a resource agreement is signed. The resource agreement should state:

- The specific purpose for borrowing funds;
- The interest rate to be applied (currently 8 percent per annum); and
- When the funds will be repaid.

Interest is payable on multiple-year borrowings that are negotiated in advance with the Department of Finance: Interest is paid initially at the budget following the end of the financial year into which money was borrowed. Interest is then paid at every following budget (i.e. in May after previous June end of financial year) on the amount still owing for every year money is owed.

Retention of Receipts

Section 35 of the *Audit Act 1901* has the effect of annotating agency appropriations by the amount of the receipts raised. These receipts form part of the running cost of agencies. Agencies may enter into an agreement with the Minister for Finance or his/her delegate and retain proceeds from:

- The sale of under-performing non-property assets;
- The sale and rental of staff housing;
- Proceeds from user charging for the provision of services (refer to Section below on User Charging);

- Sub-leasing of property or resale of goods used in fitting out premises, and other minor categories of receipts.

Section 35 Agreements should:

- Identify sources of funds;
- Specify estimates of receipts;
- Specify sharing arrangements (if applicable);
- Specify the financial period for the agreement;
- The accounting bases (cash or accrual); and
- Any specific reporting requirement.

Section 35 agreement must be renewed (or extended) every time an appropriation bill before Parliament references the arrangement (i.e. at budget and additional estimates). Renewals and extensions must:

- Make reference to the original agreement;
- State the intention of the parties to extend the time period or amounts detailed in the original agreement;
- State whether the conditions contained in the original agreement apply or detail any variations(s) to the original agreement;
- State the period for which the renewal is effective;
- State the estimated receipts for the period; and
- Be signed by appropriate department or agency delegates.

Agreements must be revised if the categories of receipts to be covered or the estimated amount of receipts changes.

User-Charging Receipts

User-charging activities are those where all or part of the cost of providing goods or services is met through charges paid by users rather than through direct budget funding.

For running cost agencies, user charging is funded through:

- net appropriation arrangements under section 35 of the *Audit Act 1901*, or
- trust account operations where the charter does not provide for fully commercialized activities.

Agencies can increase user-charging receipts for any activity by up to $1m per annum without an adjustment to the level of funding provided by the budget. An increase of over $1m will result in any budget funding for the cost of that activity being withdrawn unless otherwise agreed by the Minister for Finance.

Agencies may retain all receipts associated with user charging where annual turnover (measured on a predetermined cash or accrual basis) are less than $10m.

If turnover is more than $10m, receipts are to be shared if there is a surplus.

- A surplus arises where receipts exceed the cost incurred by an agency in producing the goods or services that are charged for.
- If receipts do not exceed the cost of provision, all receipts are retained by the agency.
- If there is a surplus of receipts over costs, it will be shared between the agency and the budget. Sharing of surplus will usually be on a 50:50 basis.

The sharing arrangements are to be applied on an agency basis against the $10m threshold unless the Minister for Finance or an authorized officer agrees to alternative arrangements.

Funds collected through net annotated appropriations that do not arise from user charges (for example, staff contributions to benefits, sales of surplus assets) will not be included in the assessment of receipts for revenue sharing purposes.

An agency is required to provide sufficient information to the Department of Finance to enable the extent of surplus to be determined.

Revenue relating to user charging activity should be identified in the annual financial statements of agencies. In addition, resource agreements may require agencies to provide special purpose reports in some cases.

As part of their corporate plan agencies are to develop a business-planning segment relating to significant user charging activities. Significant user charging activities are those which exceed the $10m threshold or involve high risk.

High Risk Activities

The Chief Executive is responsible for undertaking a risk assessment of the activity in association with annual planning arrangements. High risk can include both financial and general dimensions, where a user charging activity may not achieve results consistent with planned objectives or costs, involve potential sensitivity for the government or has potentially significant budgetary or contingent financial liability.

The Chief Executive is responsible for advising the portfolio Minister. If the portfolio Minister agrees with the Chief Executive's assessment, enhanced monitoring and accountability arrangements should be established in consultation with the Department of Finance.

ANNEX 9:
CHINA'S INTERGOVERNMENTAL FISCAL RELATIONS

As local governments and their NPOs control the bulk of EBFs, implementation of SC 29 will have a direct and important effect on local budgets. By sharply restricting the authority to impose fees and levies, the proposed changes to EBF under SC29 have the potential effect of significantly reducing resources accruing to local government. The problem is especially serious for rural governments (affecting directly township governments, but by extension also county governments).

Lacking the authority to impose taxes under the fiscal system, EBF (and self-raised funds) have been used by local governments as *de jure* taxing mechanisms. This has been tolerated and even condoned by the authorities. For example, while all levels of government depend to varying extents on users' fees, asset sales and other nonbudgetary resources, at the township level there is explicit official recognition of nonbudgetary sources for financing government–since their founding in 1986, township finance bureaus have been required to report receipts and expenditures of "three types of funds": budgetary, extra-budgetary, and self raised funds. A State Council decree in 1991 explicitly permitted township governments to impose a fee on TVEs to finance agricultural subsidies, called the "using industry to aid agriculture" fee.

The blurring of budgetary and extra-budgetary concepts at the level of local governments is exemplified by the reference to off-budget funds as "the second budget", whose uses are virtually identical to those of budgetary revenues. They are spent on education, health, farmland investment, road maintenance and construction, family planning services, administration (paying salaries and subsidies for cadres), etc., in ways that clearly supplement the budget. At the subnational level, governments often make explicit transfers from EBF to augment budgetary revenues and to cover budgetary expenditures. Virtually everywhere off-budget resources are the main source of finance for infrastructural investments.

In implementing SC29, the government must therefore pay particular attention to revising intergovernmental expenditure or revenue assignments to provide incentives for local compliance and avoid creating new forms of off-budget finance. While it is necessary to curb the proliferation of funds and levies, the MOF must take into consideration that EBF have been an important source of local finance. These funds cannot be simply eliminated or recentralized without imposing increased pressure on local finance. Reform in the management of EBF thus creates an urgent need for accelerating the pace of reform in intergovernmental fiscal relations.

An appropriate system of intergovernment fiscal relations (IFR) is critical to achieving efficient public expenditure management in China where the fiscal system is so decentralized. This is because a larger share of expenditures in the hands of local governments can affect aggregate fiscal discipline, as local governments are not concerned with maintaining macro stability; despite legal barriers, local governments sometimes borrow to finance their deficits. The sharing of spending responsibilities sometimes leaves no one in charge of aggregate budget balancing. Moreover, with the central budget accounting for less than 30 percent of expenditures, ensuring that the composition of budget expenditures reflects national or social priorities requires

that local spending be aligned with these priorities. The present system of IFR is poorly designed to achieve such harmonization, as it provides neither the right incentives nor a good match between expenditure responsibilities and revenue capacity.

Through the transition period, IFR in China has been plagued by problems of inadequate revenues as the budget declined as a share of GDP, overlapping and murky divisions of labor whereby several levels of government share responsibilities for investment in economic development, education, and health care; and inadequate equalization transfers that left large disparities in the provision of basic services across regions. At the lower end, the levels of provision for basic education and health fall far below standards set by national policy and their inadequate provision may be preventing the spread of growth and its benefits from reaching the poorest regions.

IFR deteriorated as governments at all levels tended to respond to fiscal pressure by attempting to devolve expenditure responsibilities while retaining control over revenues assigned to them. Thus, revenue assignments became increasingly mismatched with expenditure assignments over time. Budgets at the subnational levels were additionally squeezed as rapid wage increases drove up the costs of providing social services and day-to-day administration, which are local responsibilities (Wong 1991). At the county level, wages and running costs of government reportedly absorb up to 80 percent of budgetary expenditures.

By the early 1990s, a climate of distrust surrounded intergovernmental fiscal relations. The central government attributed the continuing fiscal decline in part to local government unwillingness to collect taxes while diverting funds from budgetary to extra-budgetary channels. Local governments saw the repeated changes in revenue sharing rules through the 1980s–when four different systems were successively introduced–as a lack of firm commitment by the central government to revenue assignments. The introduction of new taxes (e.g. the Energy and Transport Key Construction Fund and the Budget Adjustment Fund) and several rounds of "borrowings" all helped to convince local governments that surplus revenues were not safe from the central government (Wong, Heady and Woo 1995).

The reform package of 1994 was centrally concerned with improving intergovernmental fiscal relations, whose centerpiece was the "fenshuizhi" (FSZ or tax sharing system) reform. The intent of FSZ was: 1) to simplify and rationalize the tax structure by reducing tax types, reducing tax rates, unifying the burden on taxpayers and reducing exemptions; 2) to raise the revenue-GDP ratio; 3) to raise the central share of total revenues; and 4) to put central-local revenue sharing on a more transparent, objective basis by shifting from the negotiated sharing of general revenues to a tax assignment system.

Under the FSZ, taxes were reassigned between the central and local governments. Central taxes (or "central fixed incomes") include customs duties, the consumption tax (CT), VAT revenues collected by customs, income taxes from central enterprises, banks and nonbank financial intermediaries; the remitted profits, income taxes, business taxes, and urban construction and maintenance taxes of the railroad, bank headquarters and insurance companies; and resource taxes on offshore oil extraction. Local taxes (or "local fixed incomes") consist of business taxes (excluding those named above as central fixed incomes), income taxes and profit remittances of local enterprises, urban land use taxes, personal income taxes, the fixed asset investment orientation tax, urban construction and maintenance tax, real estate taxes, vehicle utilization tax, the stamp tax, animal slaughter tax, agricultural taxes, title tax, inheritance and gift

taxes, capital gains tax on land, state land sales revenues, and resource taxes derived from land-based resources. Shared taxes consist of the VAT, which is shared at the fixed rate of 75 percent for the central government, and 25 percent for local governments; and the new securities trading tax, which is shared equally between the central and the local governments.

Since FSZ was implemented, significant improvements have been achieved in the first three objectives. The tax structure is greatly simplified. The VAT has replaced the product tax and has been implemented basically at a uniform rate of 17 percent. The enterprise income tax structure has been merged, so that SOEs and COEs and other enterprises are all on the same tax schedule, and the top rate has been reduced from 55 percent to 33 percent. The enterprise profit and tax contracting has been largely eliminated, hardening enterprise tax obligations.

Some success has also been achieved with the second objective of revenue mobilization. In 1991 and 1992, revenue elasticity (percent growth in revenues divided by percent growth in GDP) had fallen to 0.44 and 0.46, respectively. In 1993 it rebounded to 0.83, partly as a result of local governments' efforts to "ratchet up" their bases as the central government promised to rebate sufficient revenues from the VAT and consumption tax to maintain local revenues at the 1993 level. In 1994 and 1995, revenue elasticity was 0.57 and 0.78, respectively (Xu 1997). These were better than the 1991 levels but still below one, so that the revenue-GDP ratio continued to fall. In 1996 this trend was reversed for the first time since the beginning of market reform in 1978, when revenues grew by 18 percent to 736.7 billion Yuan. This trend has continued through 1997 and 1998, with the revenue-GDP ratio rising to about 13 percent, giving rise to some optimism that FSZ is succeeding in reversing the fiscal decline.

The third objective of raising the central share of revenues was achieved in 1994, when the one-time transfer of the bulk of VAT and CT revenues to central coffers boosted the central share from 22 percent of total revenues to 55.7 percent. Since then, however, the central share has fallen steadily, to just below 50 percent in 1996, because local taxes have grown faster than VAT and CT revenues. Figure A9.1 shows the changes in the central share of revenues and expenditures since 1978.

The mixed effect of FSZ on recent trends is highlighted in Figure A9.2. While FSZ has recentralized revenues, by policy design it has not altered the continuing decentralization of expenditures. Indeed, central own expenditures have fallen from 33 percent of the total in 1990 to 29 percent in 1998.

It is in the area of improving intergovernmental fiscal relations that the FSZ reform appears to have produced the most disappointing results. In one sense, this is not surprising: local governments simply do not like giving up "ownership" of revenues and yielding control to the central government. Even after five years, the premise that taxes belong to the central government unless specifically assigned to the localities is widely resisted at the local levels. That central transfers are now accounting for nearly half of total local expenditures means a reduction of local autonomy over allocative decisions.

Other factors contribute to the unpopularity of FSZ and the lack of improvement in intergovernmental fiscal relations. One is complexity. By setting uniform rates of sharing across provinces for the VAT, CT and securities trading taxes, the FSZ was intended to make the revenue sharing process more open, transparent and objective. In the process of implementation, several distortions have emerged that have made the system far more complex–the common

saying is that the system of revenue sharing in China is such that "insiders find it impossible to explain, and outsiders find it impossible to comprehend" (*neihang shuobuqing, waihang tingbudong*).

Figure A9.1: Changing Central Shares

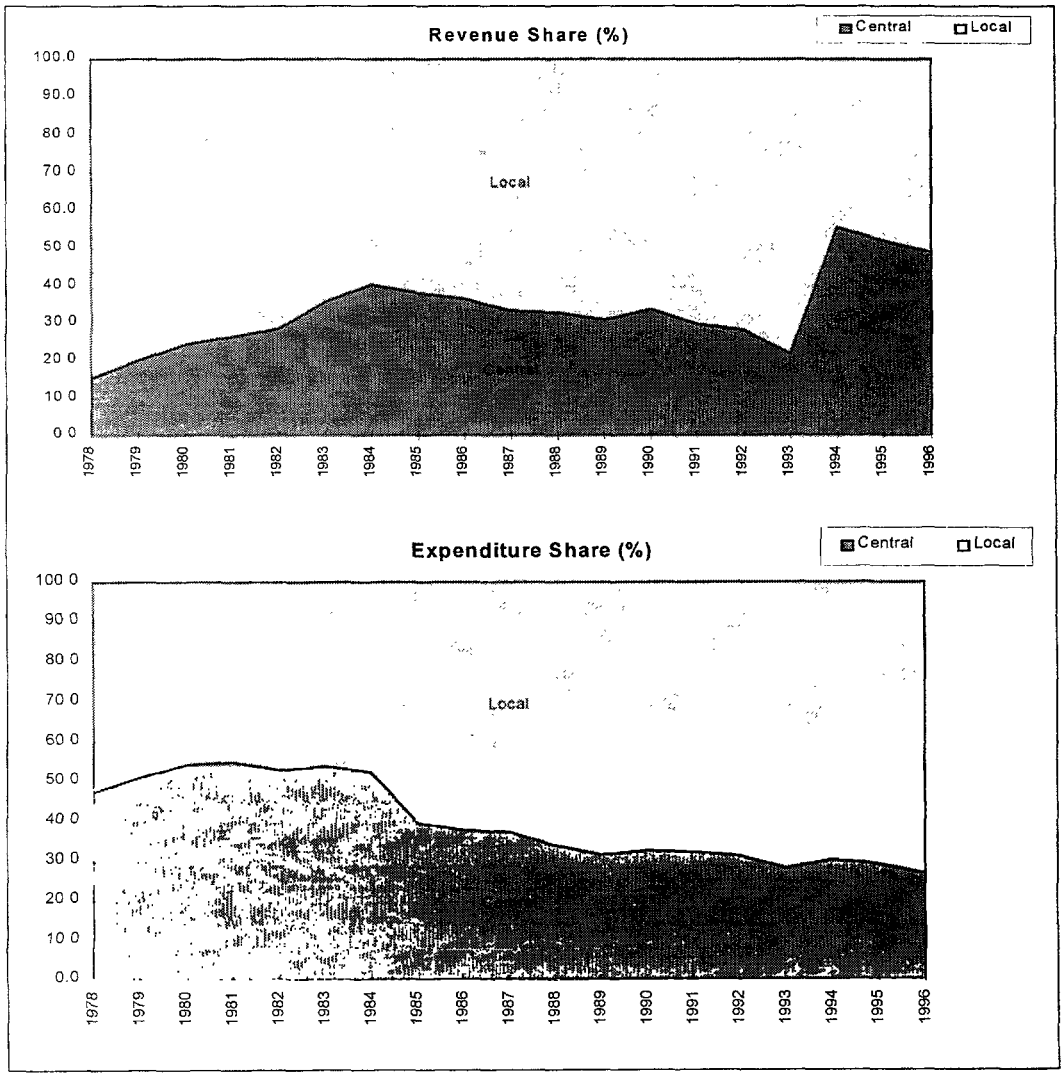
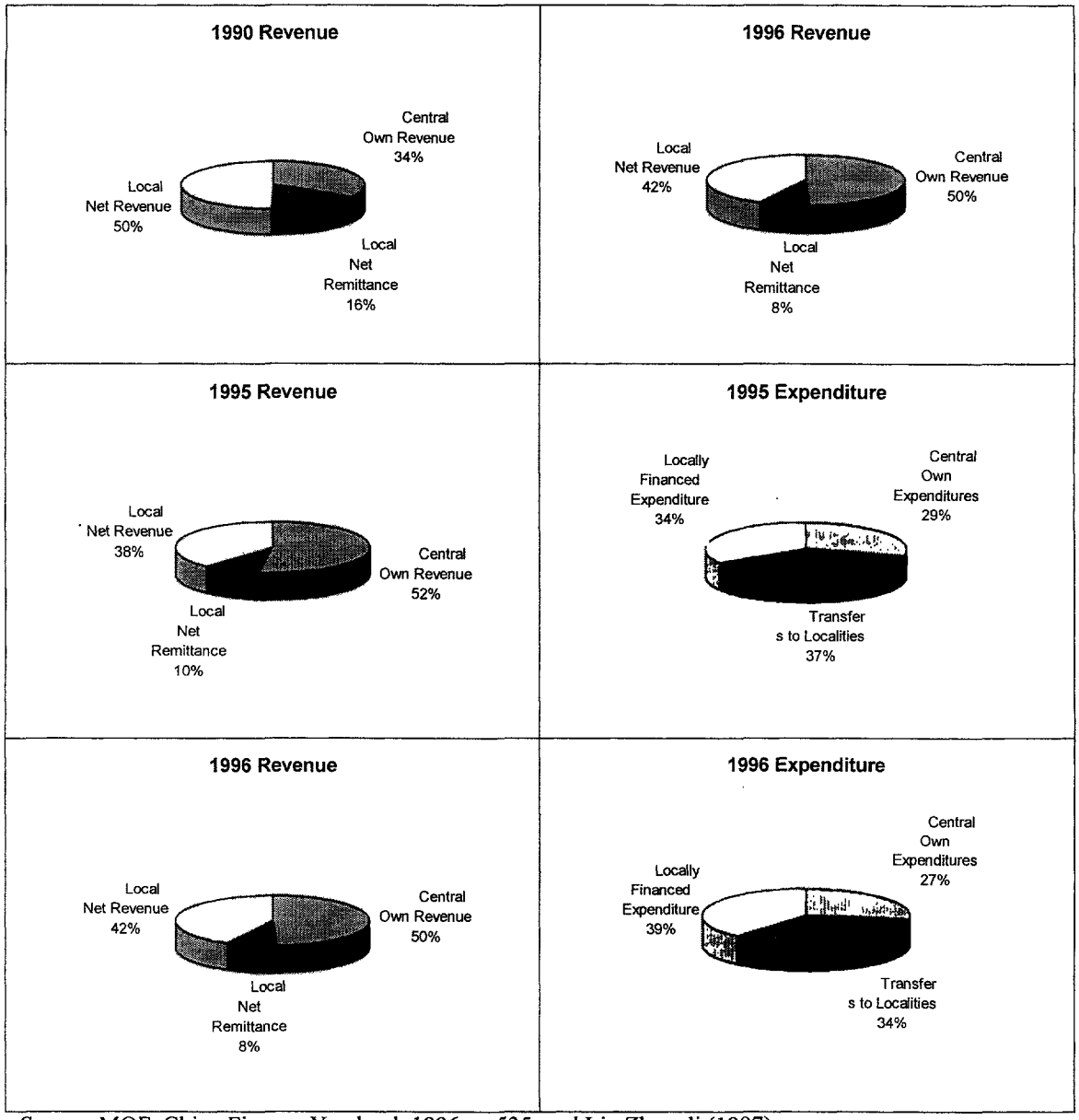


Figure A9.2: Central Revenue and Expenditure After Local Transfers



Source: MOF, China Finance Yearbook 1996, p. 535, and Liu Zhongli (1997).

The Calculation of Tax Rebates

The goals of uniformity and transparency were compromised at the outset when the central government agreed to accept the status quo distribution in 1993. This committed the fiscal system to the "simultaneous use of two systems", with a form of contracting being retained (with quota subsidies to the poor provinces and tax rebates to all provinces to make up the gap between local revenues under the FSZ system and the retained local revenues in 1993), and FSZ being applied only at the margin, to *incremental revenues*.

Available local revenue now consists of the following:

Local taxes + central transfers

= LT + LT increase + 0.25 x (VAT+ VAT increase) + 0.3 x [0.75 x (VAT increase) + (CT increase)] + contracted tax rebate + other central transfers

where:

contracted tax rebate = PBR - LT - 0.25 x VAT

and PBR is the province's base retained revenue

LT is the province's local tax revenue in the base year (1993)

VAT is the VAT revenue from that province in the base year

CT is the consumption tax revenue from that province in the base year

This reduces to:

Available local revenue = PBR + LT increase + 0.475 x VAT increase + 0.3 x CT increase + other central transfers

Implementation at the subprovincial levels. Even greater complexity is introduced in the application of the FSZ system to subprovincial levels, which differs across provinces. The reform package had specified only the assignment of taxes between the central and provincial governments, and left it to each province to determine how to share the subnational portion among the lower levels. Some provinces have simply passed through the formula for sharing to lower levels, while some provinces and prefectural units have added their own layers to the tax sharing system. For example, in Guizhou, the province takes 10 percent of the locally retained 25 percent of VAT, and 50 percent of the incremental portion of four local taxes–land occupation tax, land appreciation tax, revenues from land leases and the resource tax. In some provinces including Liaoning and Jiangsu, many local taxes are shared between the province and municipalities. The proliferation of shared taxes at the subnational levels not onlymakes revenue assignments to subprovincial units more difficult to calculate, but it also introduces inequalities across provinces that may distort incentives.

The Introduction of Revenue Growth Targets

The FSZ system was also complicated by the revenue growth targets (*kaohe zhibiao,* or reference targets) that were introduced by the MOF in 1994, as a retaliatory measure aimed at provinces that were suspected of having artificially inflated revenues in 1993. The announcement in August 1993 that 1993 would be used as the base year for the FSZ reform led to a surge in tax collection during September-December, when turnover tax revenues for the year increased by 49.6 percent over the 1992 figure. It was suspected that many provinces inflated their collections by calling in not only tax arrears but may have persuaded enterprises to pre-pay their 1994 tax obligations. To prevent these provinces from gaining and to ensure revenue growth in 1994 and after, the MOF sets targets for revenue growth for each province, with the threat of reductions in base revenues for those provinces that failed to meet their target.

The effect of these reference targets was to increase fiscal pressures on subprovincial governments, and these pressures in turn spawned ever more creative systems of rewards and punishment. Even though MOF has not issued revenue growth targets since 1994, the practice seems to have continued at the subnational levels. For example, Puding County, a nationally

designated poor county in Guizhou, received a revenue growth target of 20 percent for 1997 from the provincial fiscal department. To meet this target, the county finance bureau has set contracts mandating revenue growth (after tax sharing with the central government) of 15 percent, 20 percent and 25 percent per year with its eleven subordinate townships and towns. Those meeting their targets will be given rewards of Y10,000; 20,000 and 30,000 for the collective, while the township leaders will get Y3-5,000. On the downside, those not meeting their targets will be penalized by amounts equal to the rewards (i.e. Y30-50,000 for the collectives and Y3-5,000 for the leaders), with the fines paid by the collective and the leaders, respectively. Large additional rewards are in store for those meeting their targets three years in a row. This is a structure that tends to exacerbate the good and ill fortunes of the townships and towns. The worry is that the widespread introduction of such incentives may give rise to falsification of fiscal data at the unfortunate localities, where officials will be tempted to report nonexistent revenues on one side of the ledger and inflate expenditure figures on the other side to avoid penalties.

The Effect of FSZ on Regional Disparities

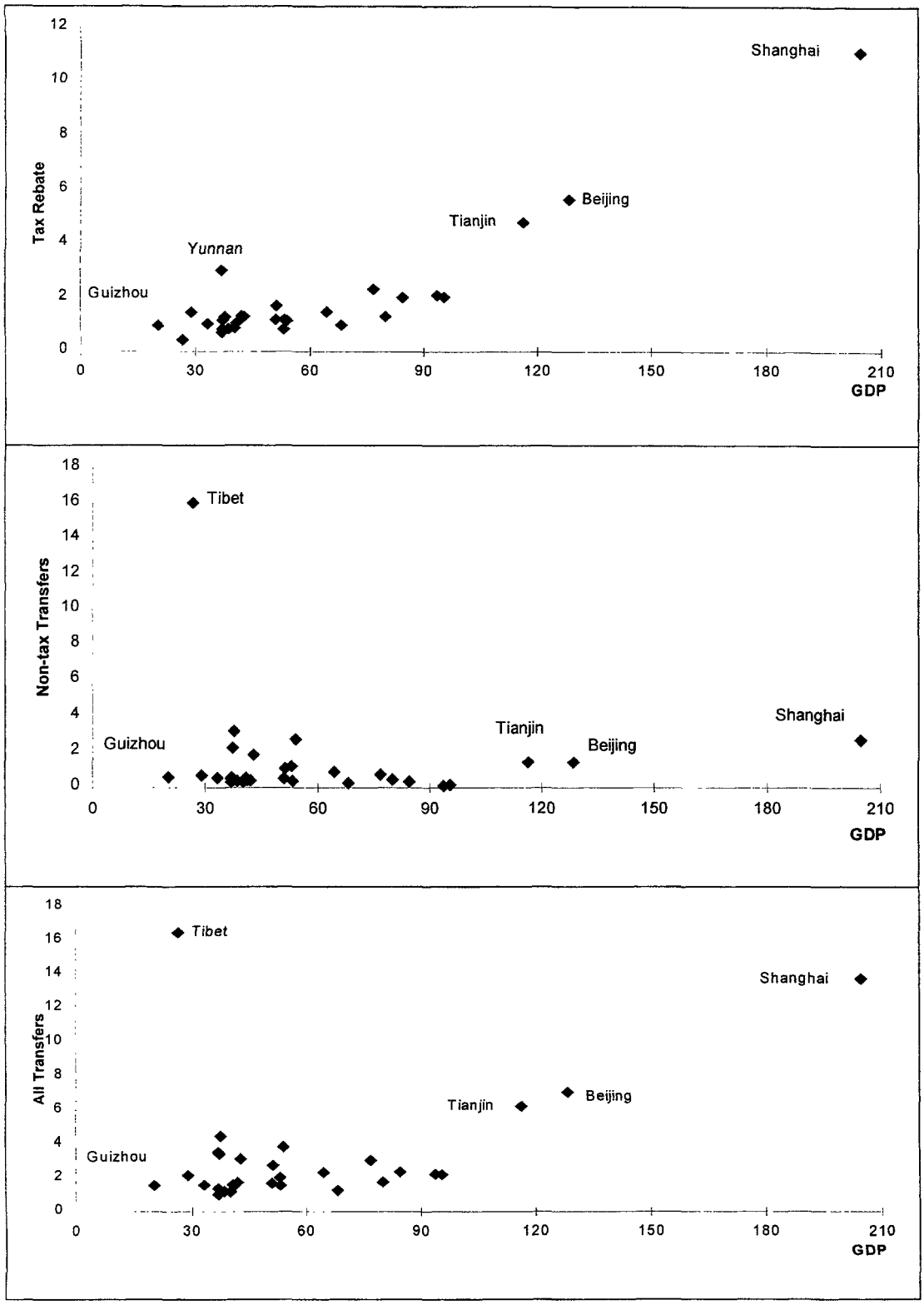
Also fueling the disaffection for FSZ is the widespread perception that it is exacerbating the unequal distribution of revenues and expenditures. This outcome was anticipated at the outset as FSZ shifted the revenue sharing principle from the previous, weakly redistributive one to the derivation principle–where transfers are pegged to collections *derived from the region*, mandating that more is returned to the revenue-rich regions (cities) than to poor ones (rural sector).

The inability of the old system to redistribute income across regions was well recognized by the early 1990s, when the search began for a new system of intergovernmental transfers that would move decisively away from the historical base numbers to a more objective, formula-driven scheme. The introduction of the FSZ system was accompanied by the strong argument that the central government needs to allocate a larger share of total revenues in order to *play a bigger redistributive role*. It is in light of that argument that the present intergovernmental transfers are disappointing, as they are dominated by tax rebates, which are strongly dis-equalizing.

In the pre-1994 system, central transfers to the provinces consisted of three components: quota subsidies, earmarked subsidies and other subsidies. In line with the "simultaneous implementation of two systems," the FSZ reform has added a fourth component of contracted tax rebates while retaining the other three.

Figure A9.3 shows per capita transfers by province in 1996. It shows tax rebates to be highly correlated with per capita GDP while there is no correlation between non-tax transfers and GDP. The bottom panel shows a positive correlation between GDP and total central transfers, attesting to the dominance of tax rebates and the overall disequalizing effect of the present system of intergovernmental transfers.

Figure A9.3: Per Capita Transfers by Provinces



Illustrative Box on Guizhou Province

The effect of FSZ on one of the poorest provinces in China, Guizhou Province, is shown in Table A9.1. Guizhou was especially hard-hit by FSZ because it was heavily dependent on taxes derived from liquor and tobacco (which had accounted for 45 percent of provincial revenues in 1993), that were reassigned as central taxes. To help cushion the shock, the MOF reportedly gave the province special consideration. Even so, provincial revenues grew faster than national revenues in 1995 and 1996 (at 24.4 percent and 27.6 percent compared to 19.6 percent and 18.0 percent for the two years, respectively), but per capita fiscal expenditure has declined in real terms. In 1995 it was nearly 25 percent less than the peak level achieved in 1991-92, making it even harder for the province to provide adequate social services to its residents.

TABLE A9.1: FSZ

Guizhou Province - Real Government Expenditure Per Capita, 1980-1996 (yuan)

Year	Expenditure (millions)	Real Expenditure (millions)	Per Capita Real Expenditure
1980	1209.4	1209.4	43.6
1981	1256.0	1227.3	43.4
1982	1413.9	1354.5	47.1
1983	1554.6	1479.1	51.0
1984	2144.1	1990.0	67.9
1985	2387.6	2057.8	69.3
1986	3038.7	2487.7	82.7
1987	3160.0	2410.5	79.0
1988	3814.4	2420.9	77.0
1989	4589.2	2480.7	77.9
1990	4858.1	2590.0	80.0
1991	5587.8	2883.9	88.2
1992	6063.3	2913.6	88.3
1993	6738.9	2820.9	84.7
1994	216.2*		73.7
1995	245.0*		68.8
1996	281.7*		72.5

Sources: Wong (1997) Table 4.4; Guizhou Statistical Bureau (1994), SSB 1995, 1996 and 1990 and Lou and Ge(1997).

Note: Deflator used is provincial consumer price index.
* per capita.

The Pilot Intergovernmental Transfer Scheme of 1995-1996

A transitional transfer payment scheme was introduced in 1995 as the first step toward a formula-driven redistributive system. The initial formula had two parts: an objective factor that attempted to measure the gap between "standard expenditures" and local fiscal capacity, and a policy component that directed subsidies to regions with large ethnic minority populations. In 1996 a third factor was added to the formula to reward good tax effort. Since then more tinkering has been done.

The 1996 formula for transfers was as follows:

Transfer to province i = f(measured fiscal shortfall of province i) + g(special transfer to province i as a minority region) + h(province i's good tax effort)

The fiscal shortfall is measured as

standard expenditure = standard wage expenses + standard administrative expenses + agriculture and other productive expenditures + other expenditures

where

standard wage expenses are derived from standard wages, number of civil servants, and a regional wage factor.

standard administrative expenses are those for government administration, police and security and other government agencies. In 1995 the actual expenditures for all government units were included. In 1996 this was shifted to including personnel and running costs for fully-funded units and lumpsum costs for units that received only partial funding from the budget.

agriculture and other productive expenditures are expenditures for agriculture and other "productive" departments.

other expenditures include price subsidies.

The policy component, or special transfers to province i as a minority region, also calculates the fiscal gap between the minority regions and the national average as

$(NR - PR_i) \times POPi$

where

NR = national per capita revenue

PR_i = province i's per capita revenue

POP_i = population of province i

[1] The figures were 9.5 billion Yuan for quota subsidies, 36 billion Yuan for earmarked subsidies, out of a total of 54.5 billion Yuan in total central transfers (Table 1.4, Wong 1997).

The coefficient $\mathbf{a_1}$ and $\mathbf{a_2}$ are determined ex post, as the ratio of funds available for transfer divided by the size of the gap. For example, in 1996 the central government had Y2.2 billion to devote to equalization transfers, compared to a fiscal gap of Y63 billion. So $\mathbf{a_1}$ was derived as 0.035. Similarly, the total fiscal gap for minority regions was estimated at Y13 billion in 1996, while the amount allocated to filling the gap was only Y1.2 billion in the central budget, the coefficient $\mathbf{a_2}$ was derived as 0.09.

Finally, the tax effort reward was derived in 1996 as follows: if province i had revenue growth in 1995 that exceeded the national average, then the total transfer to province i would be supplemented by the coefficient $\mathbf{a_3}$, where

$$a_3^i = 0.5 \text{ x } (r^i - r)$$

and

r^i = revenue growth of province i

r = national revenue growth

so that

(Transfer to province i)$_t$ =

$$\{(1+ a_3^i) \text{ x } [\, a_1 \text{ x (standard expenditure}_i - PR_i \text{ x } POP_i) + a_2 \text{ x } (NR - PR_i) \text{ x } POP_i]\}_{t-1}$$

and

t = current year, t - 1 = previous year

In other words, the transfer to province i for 1997 will be based on its fiscal gap and tax effort in 1996.

While this scheme is a welcomed first step toward a formula-based system of intergovernmental transfers, it should be recognized as a transitional scheme aimed at solving the urgent problem of meeting payroll in some provinces. It does not obviate the urgent need to get a more appropriate transfer scheme installed.

Recommendations for Improving the Pilot Scheme

For the transfer scheme to be effective, it must be more adequately funded. The scheme was allocated only Y2 and 3.46 billion in 1995 and 1996, respectively. This comprised just over one percent of the total of nearly Y300 billion in central transfers to the provinces in 1996 and was dwarfed by the tax rebates of Y195 billion. Because of the small sums allocated, their effect on the distribution of fiscal resources is marginal: the coefficient $\mathbf{a_1}$ and $\mathbf{a_2}$ are very small, so that the scheme provides only a very weak link between a province's fiscal need and their transfers.

At present the scheme mixes two sets of considerations: fiscal need and support for ethnic minority regions. These objectives should be kept separate, with one equalization scheme that provides transfers according to need (plus a tax effort factor), and the other scheme to support ethnic minorities, reported separately. The total of Y3.46 billion spent on the pilot

scheme in 1996 was in fact split into Y2.2 billion for the equalization scheme, and Y1.2 billion for the minorities' scheme.

The transitional scheme duplicates the old pre-1994 equalization transfers under quota subsidies, which totaled Y11.1 billion in 1996, and they were heavily biased toward minority regions. These schemes should be merged as soon as possible–if the pilot scheme is considered an improvement over the quota subsidies, then it should simply absorb and replace the quota subsidies.

The tax effort measure takes the gap between national revenue growth and the provincial revenue growth. This is a convenient proxy that should be replaced by better measures, as better data becomes available. Provincial revenue growth depends on too many factors other than tax effort, most notably economic growth and structural change.

Finally, it is urgent that a model that measures fiscal needs more appropriately replace the pilot transitional scheme. At present, the measured fiscal gap only considers the personnel and running costs of government, with wage costs weighing heavily. This reflects the short-term concern in meeting payroll requirements. In the long run, however, it is more appropriate to look at fiscal needs in terms of the costs of providing services such as education, healthcare, government administration, public transport, water, sewerage and sanitation services. This package of fiscal needs should contain not only wages and running costs but also some capital costs for building schools, clinics, roads, etc. Regional cost differentials in providing these services must also be included in the calculation of fiscal need–the present regional factor contains only a small differential for wage supplements and is insufficient.

Expenditure Assignments

The single biggest problem in expenditure assignments in China is the separation between spending authority and financing responsibility. On paper the intergovernmental division of expenditure responsibilities in China is roughly in conformity with that dictated by public finance theory and reflected in international best practices (see Annex 10). The central government is responsible for national defense, external relations and overall economic development, while local governments are responsible for day-to-day administration (including maintenance of public order), social services and local economic development. Some sharing of responsibilities is inevitable, especially in investments for economic development–capital construction, human development and research and development activities.

However, this rational division of responsibility is often undermined by the pernicious legacy of central planning, under which the central government continues to make policies that affect spending at the lower levels, usually without compensation or even consultation. Some egregious recent examples of such practices include the policy on grain pricing and procurement, which reportedly cost the government of Jilin Province more than Y 2 billion in trading losses in 1996, or one-quarter of the provincial budgetary revenues (Fang 1997, p. 7).[2] Another was the civil service wage reform in 1993, which raised pay rates for all civil servants and increased the cost of administration for central and local governments alike. Yet another example was the

[2] The policy calls for government grain bureaus to procure all offered grain at the state protective price regardless of market prices. The trading losses were due to a bumper harvest in Jilin during 1996, when market prices fell.

decision in 1997 to create pension pooling for SOE workers at the municipal level, which created a potentially ruinous burden for municipal finances at the prevailing high stipulated pension levels, low retirement ages and low contribution rates. Many other examples can be cited where policy was made at the central level even though fiscal decentralization had transferred the burden of financing to lower levels of government–these are the source of recurrent local complaints that "the central government throws dinner parties but leaves local governments to pay the bills".

The Budget Law implemented in 1994 guarantees local budget autonomy, but does not spell out the exact division of responsibility between levels of government, nor does it protect local budgets from unfunded mandates imposed by higher levels of government. The comprehensive fiscal reform package similarly neglected to redress issues of expenditure assignment even while it shifted revenues significantly to the central level.

The different pace of incremental changes in revenue and expenditure trends means that after nearly two decades of market transition, intergovernmental revenue and expenditure assignments are significantly mismatched. This problem has been exacerbated since 1994: the reduced share of local revenues means an increased dependence on central transfers, especially in earmarked grants whose uses are stipulated by central policy. The spate of recent laws and regulations stipulating budgetary expenditure on agriculture to increase at a rate exceeding revenue growth, or for expenditures on education to reach 4 percent of GDP, etc., all affect recurrent expenditures in local budgets, further eroding allocative powers of local governments. Finally, the attempt to extend budgetary control over EBF will further undermine local government resources and allocative power. All of these run counter to the spirit and intent of the Budget Law.

Some steps to fix intergovernmental fiscal relations:

1. Amend the Budget Law to confer real autonomy on local budgets by protecting them against imposition of unfunded mandates. Local governments should be given the right to demand compensation for costs imposed by central policies.

2. For services deemed to be of national importance, the government should consider re-centralizing their financing. In many OECD countries, for example, the central government retains some financing responsibility for health and education even though services are provided at the local levels.

3. The large income disparities across provinces in China make a compelling case for allocating substantial funds to equalization transfers to ensure minimum standards for key social services such as basic education, public health and social security. A better intergovernmental transfer scheme should be adopted that pegs transfers to measured fiscal needs. This scheme should absorb and replace the "old" quota subsidy scheme. Funds devoted to such a scheme should start off at a modest but meaningful level and increase gradually.

4. Local governments should be given sufficient revenues to finance the bulk of their expenditure responsibilities–achieving a better match between expenditure and revenue assignments to encourage better tax effort at the margin. This should be coordinated with the reform of EBF. To enlist the help of citizens in preventing the imposition of unreasonable levies, the government may consider setting up mechanisms to allow citizens to lodge complaints.

5. Local governments should be given greater autonomy for setting local taxes and users' fees. They should also be permitted to borrow under supervision for infrastructural investments.

6. The government should clearly define the revenue division and tax assignments for the different levels of government, ensuring the uniform extension of FSZ to subprovincial levels. Since the most important service responsibilities–for basic education, public health, and day-to-day administration –reside at the lowest levels of government, and as these levels are currently under-funded, the provincial level should not be allowed to retain additional funds. Instead, the formula used for center-provincial sharing should also be applied to sub-provincial sharing. As for the fifteen local taxes, they should all be allocated to the same level of government to avoid the expense of setting up local tax bureaus at more than one level. Thus they should be allocated to the level of government that is mainly responsible for providing health, education, and social services.

7. The system of earmarked grants should be revamped. At present there are hundreds of categories of earmarked funds at the provincial, prefectural and county levels. Most of these grant categories are legacies of the period of more centralized budget management, especially in the allocation of investment funds. Most categories are under-funded, so that earmarking is either ineffective or hampers the ability of local governments to respond to local needs. Earmarking should be confined to those few cases where investment projects have regional or national impact, or where it will ensure that aid for poor communities does reach its intended beneficiaries.

ANNEX 10:
EXPENDITURE ASSIGNMENT:
THEORY AND SOME INTERNATIONAL EVIDENCE[1]

Introduction

Government involvement in the economy differs widely among countries, both developing and developed. General government expenditure and net lending in 1987 was on average 41.3 percent of GDP for the industrialized countries and 35.18 percent of GDP for developing countries, but it was as low as 9.7 percent for Paraguay and as high as 55 percent for Brazil and 64 percent for Hungary in the same year.[2] For China, the figure is about 21.6 percent of GDP for 1994. Perhaps less quantifiable but as pervasive and diverse as expenditures is government involvement in the economy through regulation and ownership of assets. The variety of government involvement reflects the diversity in norms and values between societies, of which government is an agent. As China becomes more and more akin to a mixed economy, government should concentrate on those goods and services for which it has a comparative advantage in provision, a topic dealt with in the theory of public goods.[3] Whether government has a comparative advantage over the market depends, among others, on the organization of government, and the division of tasks over levels of government, the topic of the first part of this Annex. This division of tasks, or expenditure assignment is logically prior to revenue assignment,[4] but is not independent, because the incentives for lower levels of government to perform tasks assigned to them depend on the way those tasks are financed. Revenue assignment will be treated in the second part of this annex.

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[1] This is adapted from Annex 3.1, World Bank, China: Budgetary Policy & Intergovernmental Relations. Report No. 11094, CHA, October 30, 1992.

[2] IMF, *Government Finance Statistics Yearbook*, 1990.

[3] See, for example, R. Musgrave and P. Musgrave, *Public Finance in Theory and Practice*, 4th ed., McGraw-Hill, New York e.o., 1984.

[4] See Anwar Shah, 1991, "Perspectives on the Design of Intergovernmental Fiscal Relations," World Bank. WPS 726, p. 2. For a discussion of tax assignment principles, see R.A. Musgrave, "Who Should Tax, Where and What?" in Charles E. McLure, *Tax Assignment in Federal Countries*, Australian University Press, Canberra, 1983.

Criteria for Expenditure Assignment over Levels of Government

Many goods and services provided by government have benefits restricted to only a part of a country, for example waste collection, local roads and police. From a normative point of view, it does not matter what level of government provides such a local public good, but a positive perspective on government–government as a complex organization of people with different interests–leads to the conclusion that decentralization, if properly implemented, can enhance economic efficiency within government and promote growth due to better policies at a subnational level. China's economic growth following the decentralization over the reform period is a prime example of this.

Decentralization is concerned with at least five aspects of a function: (a) the choice of objectives; (b) the choice of instruments; (c) the administration and implementation of a program; (d) the financing of the program; and (e) the control of a program. Usually one distinguishes three types of decentralization, depending on the degree of autonomy of subnational governments and depending on whether decentralization takes place within the administration: (a) deconcentration: subnational units of central government administer and implement national policies; (b) delegation: subnational governments perform policies decided upon by the national government, but with some autonomy in the choice of instruments or finance is present; (c) devolution: subnational governments decide on goals, instruments, implementation and finance of a policy, but sometimes with cofinancing and central government control. In China, due to the double accountability of subnational government units to both local People's Congresses and central government units, the distinction between the types of decentralization is not always clear-cut. For instance, local Education Bureaus act as agents of the Ministry of Education concerning national universities (deconcentration); they have some autonomy concerning finance and instruments of primary education, if national goals are met (delegation); and they are largely autonomous concerning local universities (devolution).

Many problems between levels of governments stem from partial decentralization of responsibility. An objective imposed by the central government is least likely to be fulfilled by a local government that disagrees, and it is less likely to perform tasks for which it is not explicitly or implicitly held responsible. Prescription of instruments for local governments to achieve certain goals may lead to inefficient implementation of the program, if local circumstances are not taken into account. Decentralization of programs without the means of finance to go with it has implications for the design of intergovernmental grants, or may put the subnational government under undue budgetary stress, if no additional finance is provided.

The theory of fiscal federalism[5] provides a strong rationale for the decentralization of decisions concerning local public goods, concisely stated in Oates' decentralization theorem.[6]

> "For a public good–the consumption of which is defined over geographical subsets of the total population, and for which the costs of providing each level of output of the good in each jurisdiction are the same for the central or the respective local government–it will always be more efficient (or at least as efficient) for local governments to provide the Pareto-efficient levels of output for their respective

[5] Fiscal federalism applies to any government with more than one layer of government, irrespective of whether the country is a federation or not.

[6] Wallis E. Oates, 1972, *Fiscal Federalism,* Harcourt Barce Janovitch Inc., New York e.o., p.35.

jurisdictions than for the central government to provide any specified and uniform level of output across all jurisdictions."

The reasons most cited in favor of decentralization are: efficiency, accountability and the benefits from competition among subnational governments.

(a) **Efficiency**. The level of government closest to the beneficiaries of the public good should make the decision on provision of public goods. The information on local preferences for public goods and on local costs is better, resulting in higher allocative and production efficiency. Also, better information on local circumstances enhances the efficiency of public investment decisions, and fosters growth.

(b) **Accountability**. Local governments can be held more directly responsible for their decisions than national ones. Besides sanctions through the political process, "voting with one's feet" can sanction local decisions by leaving the jurisdiction, which erodes the local tax base, in principle forcing the government to adjust. The corrective mechanism of exit only works if the tax base is allowed to change in reaction to bad policy and if interest of the local government in the local tax base exists. If local governments were financed completely by central government grants, they would have no interest in conducting policy to the benefit of their constituents, as their sources of revenue does not depend upon it. Moreover, transparency of government decisions and their consequences is a condition for the "exit" and "voice" mechanisms to work.

Besides political accountability, financial accountability and managerial accountability can be distinguished. Financial accountability refers to government spending being in accordance with the appropriations and is usually exercised by parliamentary committees or auditors from higher-level government. Managerial accountability refers to the efficiency of public goods provision, if a lower level of government acts as an agent of the central government. The less political accountability is, the more important financial and managerial accountability becomes. Decentralization improves accountability since it reveals information about the most efficient way of providing a certain service. Thus, even if the objectives and responsibility of a program lies with central government, subnational governments may outperform a national agency in administration and implementation of the policy. For financial and managerial accountability to be effective, an accurate accounting system, with regular and detailed reviews of government operations in financial and economic terms, is a requirement.

(c) **Competition and Innovation**. As in markets for private goods, competition among jurisdictions may enhance the provision of efficient public goods, because new and more cost-efficient methods are more likely to be found when more jurisdictions search independently for them. The best practice thus found can be imitated by other localities. Local government's interest in its own tax base is again essential for the competitive mechanism to work. Of course, learning from others is not restricted to national boundaries, but national innovations may be more relevant to national circumstances. A more subtle gain from competition arises, once imperfect information is considered. In such circumstances, mistakes are due to occur, but the impact of the mistake is far less pervasive in a decentralized system than in a centralized system in which an erroneous policy is implemented nationwide.

Not all government tasks can be decentralized. Arguments against the decentralization of government functions are:

(a) **Imperfect Mobility of People**. The corrective mechanism of voting with one's feet–leaving a jurisdiction with a suboptimal level of public goods–may be inoperative if the costs of moving are high. Legal restrictions against the mobility of people equally give the local government more discretion in diverging from the preference of its constituents. In various countries, the political process is inadequate for the expression of local preferences concerning local public goods. Unfortunately, the same situation usually prevails at higher levels of government, and thus centralizing the provision of local public goods may not improve the situation in this respect. However, if the mechanism of voting–both with one's feet and at the ballot–is not in operation, managerial accountability of local governments may partially replace it. In such a situation, efficiency would still be enhanced by decentralization, because then the central government has more evidence to judge the individual local government on the efficiency of providing a service. In addition, the competitive argument mentioned above also holds if local governments only face managerial accountability to higher levels of government.

(b) **Spatial Externalities**. Local public goods may have positive or negative effects in other jurisdictions, which are not taken into account by the government supplying them. The limiting case is a national public good, such as national defense, or foreign policy, which ought to be supplied by the central government. More often, the spillovers are limited to neighboring jurisdictions (people from a metropolitan area using facilities in a city, such as roads, museums), and could in principle be dealt with by horizontal intergovernmental financial compensation, or other forms of intergovernmental cooperation, without centralizing the provision of the service. Broader application of user charges for services with spillovers may reduce the importance of spatial externalities, because then the benefits of services would be internalized.

Local government competition may lead to spatial externalities: local governments can offer benefits to their constituents at the cost of others outside the constituency. Examples are: the loosening of environmental standards in a locality, when the environmental degradation takes place in another locality due to spillovers; the imposition of high taxes on a local firm, which has a national monopoly and can thus shift the tax burden to nonconstituents; and the exemption of certain taxes of which the revenue is only partially local. As with externalities in the private sector, detrimental effects from competing local governments are often due to an inappropriate regulatory framework, in which the full costs and benefits do not accrue to the localities themselves.

The fear of tax competition among jurisdictions sometimes keeps governments from decentralizing the tax base, thereby reducing the responsibility of the local government for its level of services. Tax competition occurs when local governments set low rates of taxation for mobile means of production, especially capital. Without coordination among jurisdictions, the outcome may be an inefficiently low national level of taxation, and therefore a suboptimal supply of public goods. The same argument would hold for other governmental intervention, such as regulation, trade policy and industrial policy, where individual policies by local governments may add up to inefficient national outcomes. Tax competition may also affect the efficiency of the private sector, because costly reallocation

of resources may be undertaken solely for tax purposes. To contain the detrimental effects of tax competition, the central government can set minimum standards of public services and taxes, or may even centralize certain functions. Functions determining the internal market of a country, such as banking and currency, trade policy and industrial policy are normally central functions in order to prevent destructive competition among local governments.

The conduct of local stabilization policy is in general not effective, due to the large spillovers across local boundaries. Increased government spending in one province will "leak" over the borders of another, resulting in too little concern with a stable economic environment. Even if no active stabilization policy by local governments is pursued, however, decisions on expenditures and taxes do affect the overall economy, and the decentralization of decision power might compound the problems for the central government in order to contain, or compensate for, those effects. Perhaps the most pervasive cyclical influence stems from government borrowing, and some means to control the impact of local borrowing will be discussed in the section on revenue assignment.

(c) **Economies of Scale**. Some services provided by governments need a minimum scale in order to operate efficiently, a scale that may not be achieved by a single locality. Again, economies of scale do not automatically pall for higher-level government intervention: intergovernmental cooperation may often be more efficient, as local governments can still be held responsible for the provision of the service. Electricity nets, sewage systems, waste collection, etc. are services that might be shared by several local governments in cooperation, thus bypassing the negative effects of administration by a higher-level government.

(d) **Administrative and Compliance Costs**. It is argued that a centralized administration leads to lower administrative and compliance costs for certain programs. For instance, redistributive tax policies are best carried out by central government, since decentralized policies to redistribute income would "drive out the rich". However, although it is clear that an individual cannot escape its tax liability from a national tax by moving, it may well be that local governments have more capabilities to monitor actual tax obligations. Consequently, the administration and implementation of a tax policy with national objectives may be delegated to subnational governments, and a share of the tax may be left at the collecting agency in order to align the goals of central and subnational governments. On the expenditure side, subnational governments may be in a better position to assess the needs for welfare support, and could take more interest in providing the right amount of support to the right individuals, if part of the welfare payments is locally funded. A more serious hindrance for decentralization in many developing countries is insufficient administrative capacity at lower levels of government, leading to production inefficiencies.

(e) **Equity**. Local income redistribution is constrained by mobility of people: a locality that has strong redistributive policies would drive out the rich and attract the poor, thereby eroding its own tax base. Even if local redistribution were feasible, the inequalities between localities would not be affected. Both reasons give strong motivation for nationwide redistributive policies.

The desire to supply every citizen with a minimum amount of certain local public goods and publicly provided private goods (education, health care) is brought up as an argument

against decentralization. The argument holds for deciding the objectives of a program, but administration, implementation strategy and financing can often be left to the discretion of lower levels of government. The problem is rather to find accurate ways to decentralize most of the decisions in order to reap allocative and productive efficiency gains, while finding ways to impose the minimum standards on the lower-level governments. National standards, central inspection agencies and appropriate grant design are often more efficient than the complete centralization of provision. Private producers or local governments can ensure personal entitlement to education or health care in the form of education vouchers and social health insurance, while maintaining the competition on the supply side of the public good.

Equity issues also play a role in the assignment of revenue sources. The decentralization of revenue sources may lead to horizontal inequities to different treatment of people in the same material circumstances, but in different localities. The equity issue can only be dealt with in the context of net benefits from the public sector: individuals may well be willing to pay more taxes for better services. Furthermore, the issue becomes policy-relevant only if there are serious impediments to mobility: if people are free to move, they settle in the locality that offers the best deal to them. Even if some inequity is created by decentralization, it should always be weighted against the efficiency gains from decentralization.

Based on the theoretical arguments, a tentative and broad division of labor over levels of government can be proposed (Table A10.1), distinguishing between service *responsibility* and service *provision*. The first is concerned with the objectives of a program or service, the second with the actual delivery of the service, and the two need not coincide.[7]

Table A10.2 shows how governments around the world assign functions among levels of government. Table A10.3 shows the actual expenditures by levels of government for a sample of 39 developing and developed countries over a three-year period. The central government administers most expenditures: in all but four countries listed, it accounted for over 50 percent and an average share in total expenditures of 72.3 percent. The spectrum is wide, ranging from Yugoslavia (23 percent) to Paraguay (95 percent). Central governments have a larger portion of expenditures in developing countries (77.8 percent) than in developed countries (65.9 percent).

[7] Moreover, service provision need not coincide with service production. For instance, local governments may be assigned the provision of local infrastructure, but the actual production of infrastructure may very well be left to enterprises outside the public sector.

Table A10.1: Conceptual Basis of Expenditure Assignment

Expenditure category	Service responsibility	Service provision	Comments
Defense	F	F	National benefits
Foreign affairs	F	F	"
International trade	F	F	"
Environment	F	S,L	"
Currency, banking	F	F	"
Interstate commerce	F	F	"
Immigration	F	F	"
Unemployment insurance	F	F	"
Airlines/railways	F	F	"
Industry/agriculture	F,S,L	S,L	Interstate spillovers
Education	F,S,L	S,L	Transfers in kind
Health	F,S,L	S,L	"
Social welfare	F,S,L	S,L	"
Police	S,L	S,L	Primarily local benefits
Highways	F,S,L	S,L	Some roads with spillovers; others primarily local
Natural resources	F,S,L	S,L	Promotes a common market

F=central government; S=intermediate government (province, state); L=local government.

Source: Anwar Shah, "Perspectives on the Design of Intergovernmental Fiscal Relations," *PRE Working Paper Series*, No. 726, Washington, D.C., July 1991, p. 6 and p. 7.

TABLE A10.2: EXPENDITURE ASSIGNMENT IN SELECTED COUNTRIES

		Defense	Foreign Affairs	Int'l Trade	Environ-ment	Cur. Bank	Interstate Trade	Immig.	Unempl. Insur.	Air Rail	Industry Agriculture	Educa-tion	Health	Social Welfare	Police	High-ways	Natural Resources	Residual Powers
Argentina:	(1)	F	F	F		F	F			F,S		F,S,L	F,S,L		F,S	F,S	F,S	
	(2)	F	F	F		F	F			F,S		F,S,L	F,S,L		F,S	F,S	F,S	S
Bangladesh:	(1)	F	F	F		F					L	L	L	L	L	L	L	
	(2)	F	F	F		F					L	L	L	L	L	L	L	
Brazil:	(1)	F	F	F	F,S	F	F	F	F	F	F,S	F	F,S	F,S	F,S	F	F,S	S
	(2)	F	F	F	F,S	F	F	F	F	F	F,S	F,S,L	F,S,L	F,S	F,S	F,S	F,S,L	S
Czechoslovakia:	(1)	F	F	F		F	F	F			S	L	L	S	F			
	(2)	F	F	F		F	F	F			S	L	L	S,L	F			
India:	(1)	F	F	F	F,S	F	F	F	F,S	F	F,S	F,S	S	F,S	S	F	F,S	F
	(2)	F	F	F	F,S	F	F	F	F,S	F	F,S	F,S,L	S,L	F,S	S	F	F,S	F
Indonesia:	(1)	F	F	F		F					F,S,L	F,S,L	F,S,L					
	(2)	F	F	F		F					F,S,L	F,S,L	F,S,L					
Japan:	(1)	F	F	F							L	F,L	F,L	F,L	L		L	
	(2)	F	F	F								L	F,L	F,L	F,L	L	L	
Malaysia:	(1)	F	F	F	L	F	F	F		F	F,S	F	F,S	F,S	F	F	S	F
	(2)	F	F	F	L	F	F	F		F	F,S	F	F,S	F,S	F	F	S	F
Mexico:	(1)	F	F	F	F	F	F	F		F	F	F,S	F,S		S,L			S
	(2)	F	F	F	F	F	F	F		F	F	F,S	F,S		S,L			S
Nigeria:	(1)	F	F	F	F,S	F	F	F		F	F,S	F,S	S,L		F	F,S,L	F,S,L	F
	(2)																	
Pakistan:	(1)	F	F			F		F	F,S	F	F,S	F,S,L	F,S,L	F,S	S	F,S	F	S
	(2)	F	F			F		F		F	F,S	S,L	S,L	F,S	S	F,S	F	S
Philippines:	(1)	F	F	F		F	F					F		F				
	(2)	F	F	F		F	F					S,L		S,L	S,L			
Soviet Union:/a	(1)	F	F	F		F				F					F			
	(2)	F	F	F		F				F	F,S,L	F,S,L	F,S,L	F,S,L	F			
Thailand:	(1)	F	F	F		F						L	L		L	L		
	(2)	F	F	F		F						L	L		L	L		
Yugoslavia:	(1)	F	F	F		F	F	F		F		S	S	S		F	F	
	(2)	F	F	F		F	F	F				S,L	S,L	S,L				
								(assignment of constitutional powers)										
Canada		F	F	F	F,S	F,S	F	C	F	F,S	C	S	S(F)	F,S	F,S	S	F,S	F
United States		F,S	F	F	F,S	C	F	C	F,S	F,S	S	S,F	S(F)		F,S	F,S	S	S
Switzerland		F	F	F	C	F	F	C	C	F,C	F,S	C,F,S	S,C	F,C	S	FS		S
Australia		F,S	F	C	F,S	C	C	C	C	F,S	S,C	F,S	F,S	C	S,F	F,S	F	S
Germany		F	F,S		C	C		C	C	F,C	C	C,S	C,F,S	C	C,S	C	C	S
Austria		F	F		F,S	F		F	F	F	F	F,S	C,F,S	C	F,S	F,S	C	S

/a Allocation of Expenditure responsibility between republics and local governments is still an open question. For row (2), the table reflects actual distribution of main expenditures between different budgets in 1989.

Notes: F = Federal/Central Government; S = State/Provincial/Republic/Departmental Government; L = Local Government; C = Concurrent Powers; (1) = Service Responsibility; (2) = Provision of Service.

Sources: Anwar Shah, *Perspectives on the Design of Intergovernmental Fiscal Relations*, *Policy Research Working Paper Series*, No. 726, July 1991; D Herpinger, *Distribution of Powers and Functions in Federal systems*, Ottawa, 1991, Appendix B.

TABLE 10.3: GENERAL GOVERNMENT EXPENDITURES AND PORTION ADMINISTERED BY EACH LEVEL OF GOVERNMENT, SELECTED COUNTRIES /a

(Average of latest three years available)

	End year	Total expen-diture	Educa-tion	Health	Social security and welfare	Total Expenditures /c			Education			Health			Social security and welfare		
						Central gov't	State gov't	Local gov't	Central gov't	State gov't	Local gov't	Central gov't	State gov't	Local gov't	Central gov't	State gov't	Local gov't
		(as percent of GDP)				(as percent of general government)											
Australia	1987	39.1	5.5	5.5	9.6	52.9	40.4	6.8	8.5	91.3	0.2	43.5	55.6	0.9	92.8	6.2	1.0
Austria	1987	51.8	..	..	..	70.4	13.7	16.9	..	..	..	..	..	..	..	..	..
Belgium	1987	56.7	..	..	..	85.9	..	11.9	..	..	..	..	..	..	..	..	..
Canada	1987	46.0	5.8	6.0	12.3	41.3	40.3	18.4	4.8	34.5	60.7	2.6	89.5	7.9	65.8	31.3	2.9
Denmark	1986	57.6	7.1	5.2	23.1	44.9	..	52.9	46.8	..	53.2	7.1	..	92.9	26.1	..	73.9
Finland	1987	43.0	..	..	..	54.7	..	45.3	..	..	..	..	..	..	..	..	..
France	1985	49.3	4.6	8.3	20.9	82.2	..	16.5	75.3	..	24.7	97.0	..	3.0	91.8	..	8.2
Germany	1983	50.2	4.2	8.0	21.2	58.7	21.5	17.9	1.0	73.8	25.2	74.4	11.2	14.4	79.0	10.9	10.1
Ireland	1987	55.8	..	..	..	72.5	..	27.5	..	..	..	..	..	..	..	..	..
Luxembourg	1987	39.1	4.4	0.7	21.3	81.3	..	25.9	74.1	..	25.9	92.0	..	8.0	97.4	..	2.6
Netherlands	1988	59.2	..	..	..	70.1	..	29.9	..	..	..	..	..	..	..	..	..
New Zealand	1981	43.2	..	..	..	86.9	..	13.1	..	..	..	..	..	..	..	..	..
Norway	1986	47.2	..	..	..	66.4	..	33.6	..	..	..	..	..	..	..	..	..
Spain	1986	38.2	..	..	..	78.7	9.9	11.3	..	..	..	..	..	..	..	..	..
Sweden	1987	61.6	..	..	..	59.8	..	40.2	..	..	..	..	..	..	..	..	..
Switzerland	1984	37.4	5.3	5.9	13.9	47.5	28.3	24.2	6.2	57.5	36.3	45.5	32.1	22.4	88.5	5.6	5.9
United Kingdom	1987	44.8	5.1	5.1	14.3	70.9	..	27.2	12.7	..	87.3	100.0	..	0.0	84.0	..	16.0
United States	1987	37.1	5.1	4.3	9.0	60.3	17.3	22.4	4.2	24.5	71.3	50.5	33.8	15.7	78.0	14.6	7.4
Hungary	1988	64.5	5.7	4.2	18.1	77.8	..	22.2	20.2	..	80.0	39.2	..	60.8	95.7	..	4.3
Poland	1988	48.1	..	..	..	77.1	..	28.9	..	..	..	..	..	..	..	..	..
Romania	1985	32.3	2.1	2.1	8.9	77.0	..	23.0	28.0	..	72.0	10.3	..	89.7	99.3	..	0.7
Yugoslavia	1987	25.3	3.2	4.2	7.8	23.2	31.4	45.4	0.0	0.0	100.0	0.0	0.0	100.0	7.3	75.9	16.8
India /b	1986	22.6	3.4	0.9	2.3	47.5	52.5	..	9.0	90.1	..	30.2	69.8	..	0.0	100.0	..
Indonesia /b	1988	22.8	3.1	0.5	0.4	88.7	11.3	..	65.3	34.7	..	72.8	27.2	..	0.0	100.0	..
Israel	1986	62.9	5.3	2.0	10.0	90.8	..	9.2	67.2	..	32.8	97.0	..	3.0	94.9	..	5.1
Pakistan	1979	26.1	..	..	..	68.2	28.3	3.5	..	..	..	..	..	..	..	..	..
Thailand	1982	21.2	4.1	1.1	1.2	92.3	..	7.7	94.8	..	5.2	93.5	..	6.5	97.4	..	2.6
Argentina /b	1987	33.2	4.0	1.1	9.1	60.3	39.7	..	33.3	66.7	..	24.4	75.6	..	89.4	10.6	..
Bolivia	1986	11.1	..	..	..	85.9	10.6	3.4	..	..	..	..	..	..	..	..	..
Brazil	1987	34.1	..	..	..	65.8	24.5	9.6	..	..	..	..	..	..	..	..	..
Chile	1987	32.3	4.9	1.9	8.8	93.8	..	6.2	81.7	..	18.3	98.1	..	1.9	100.0	..	..
Colombia	1984	18.0	5.5	1.3	3.2	67.4	23.9	8.7	55.5	39.2	5.3	49.0	40.2	10.8	90.0	7.8	2.2
Mexico	1984	30.2	..	..	..	90.1	7.6	2.3	..	..	..	..	..	..	..	..	..
Paraguay	1984	11.3	..	..	..	95.1	..	4.9	..	..	..	..	..	..	..	..	..
Kenya	1984	29.3	5.2	2.1	1.4	94.3	..	5.7	94.0	..	6.0	91.9	..	8.1	75.9	..	24.1
Malawi	1984	29.1	3.7	2.2	0.6	93.7	..	6.3	98.7	..	1.3	82.9	..	17.1	100.0	..	0.0
South Africa	1986	33.3	..	..	..	74.8	12.5	12.7	..	..	..	..	..	..	..	..	..
Tunisia	1982	34.0	5.1	2.5	4.7	94.6	..	5.4	100.0	..	..	100.0	..	..	100.0	..	0.0
Zimbabwe	1986	45.0	8.3	2.6	3.0	75.8	..	24.2	60.2	..	39.8	..	..	..	100.0	..	0.0
USSR /d	1990	50.6	5.2	2.9	7.4												
Russian Federation /d	1992	41.0	..	..	..												

/a Excluding intergovernmental grants.
/b Data for general government do not include local government.
/c Includes supranational authorities share of general government expenditures. Source: Levin (1991).
/d Data for USSR and Russian Federation is from Table 1.3 of World Bank Report "Russian Intergovernmental Fiscal Relations in the Russian Federation."
Note: General Government is central plus subnational government plus social security agencies.

ANNEX 11:
A FORMULA-BASED EQUALIZATION TRANSFER SYSTEM FOR CHINA: MODEL AND SIMULATIONS

The current Chinese central-provincial fiscal transfer system consists mainly of three mechanisms[1]. The first mechanism is based on the old contract system prevailing during 1988-1993. That is, after 1994, the localities (provinces and cities with independent planning status) continue to remit revenues to or receive transfers from the center according to their fiscal contracts in effect in 1993. The second type of transfer is "returned revenue" from the center according to a calculation that ensures that each locality retains no less than what it did in 1993. These two types of transfers are general-purpose transfers, or unconditional transfers. The third type of transfer includes various specific-purpose grants, such as those for price subsidies, educational projects, environmental projects, disaster relief and the development of poor regions.

The general-purpose transfers from the center to the localities account for the major part of the total transfers. In 1994, the central government's net transfer to the local governments amounted to about 181 billion Yuan, of which two-thirds were general-purpose grants. However, these general-purpose transfers suffer from at least two major flaws. First, they were not designed to address the increasingly significant regional disparity issue; rather, they were largely designed to recognize the vested interests of the localities[2]. Second, the criteria by which these transfers are allocated are rather ad hoc; that is, the transfer system lacks scientific measurements of fiscal capacities and fiscal needs. This can easily lead to an unjustified distribution and encourage the localities' bargaining activities.

This annex presents an illustrative equalization transfer model and the simulation result using 1994 data on China. It provides the estimates of fiscal capacities and fiscal needs of 30 Chinese provinces using the methods discussed in the paper. Based on a formula that aims to ensure that provinces with similar levels of tax effort be able to provide similar levels of public services, the calculation results in a set of hypothetical transfers from the center to the provinces in 1994. These results are then compared with the actual transfers made to the provinces in 1994.

The method used to calculate the provincial fiscal capacities and fiscal needs may be considered overly simplified and the quality of data can certainly be improved. Nevertheless, the estimation carried out here is simply intended to provide an illustrative example of how an equalization transfer formula with a minimum data requirement can be constructed. The following sections discuss the methodology and the results.

Estimating Fiscal Capacities

[1] In 1996, a formula-based equalization transfer system was introduced on an experimental basis. This system applies a formula that uses objective variables to calculate local fiscal capacities and needs. However, the size of this transfer program was only $2 billion Yuan, or 0.5 percent of the central government revenue.

[2] According to some studies, China's regional disparity is among the highest in the world.

Two methods were tried to determine the fiscal capacities of the provinces, that is, the revenue each province would be able to collect with an average level of tax effort. The most important element in this calculation is the estimation of the provinces' tax bases. The first method uses provinces' GDP levels as proxies of the tax bases. To see how well GDP can forecast revenue, an OLS regression of a linear equation with no intercept is conducted. The result is:

$$\text{Regression I: } REV_i = 0.0186GDP_i \quad (1)$$

R-square = 0.75, No. of observations = 30, Degrees of freedom =28

where REV_i represents revenue collected province i in 1994, and GDP_i is the value of province i's gross domestic product in 1994. The result suggests that the differences in GDP can explain 75 percent of the variations in revenue across provinces.[3]

Instead of using an output measure such as GDP as a proxy of the tax base, the second method attempts to estimate the local tax base using two variables: the total retail sales and the before-tax profits of industrial enterprises. This is based on the assumption that business tax and personal income tax–the two major local taxes–are positively correlated with total retail sales, and another major local tax–corporate income tax–is positively correlated with profits of industrial enterprises.[4] Using these two variables as explanatory variables, the second regression yields a better fit:

$$\text{Regression II: } REV_i = \underset{(4.90)}{0.0896}\, SALES_i + \underset{(2.84)}{0.1679}\, PROF_i \quad (2)$$

R-square = 0.88, No. of observations = 30, Degrees of freedom =28

where $SALES_i$ is province i's total retail sales in 1994, and $PROF_i$ is the profits of the province's state-owned industrial enterprises in 1994. Roughly speaking, the regression results suggest that if all local taxes are levied on these two bases, the national average effective tax rate on total sales is 8.96 percent, and the national average effective tax rate on corporate profits is 16.8 percent. The R-square of 0.88 suggests that 88 percent of the variations in revenue collection can be explained by variations in these two variables.[5]

Because the second method represents a better forecast of actual revenues, it is used to estimate the provinces' fiscal capacities. That is, the following equation is employed to estimate the fiscal capacities of the provinces:

$$C_i = 0.0896\, SALES_i + 0.1679\, PROF_i \quad (3)$$

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[3] When the structure of the economy (percentage of agriculture in GDP) is added to the regression as the second explanatory variable, R-square improves only slightly to 0.77, and its coefficient is not statistically significant.

[4] Twenty-five percent of VAT assigned to provinces is not considered as local tax in this exercise, as it is included in the transfer calculated from the actual local revenue and expenditure figures.

[5] To find out whether individual disposable income (the tax base for personal income tax) is important in determining revenue, this variable is added to the regression but yields no improvement in the R-square. When tax effort (revenue/GDP ratio) is added to the above regression, the R-square further increases to 0.94. However, to forecast the provinces' fiscal capacities, one should eliminate the impact of tax efforts by leaving out this variable.

where C_i is the fiscal capacity of province i. The estimated fiscal capacities are reported in Table A11.1

Estimating Fiscal Need

The fiscal need of each province is broken down into seven categories: education, health, social welfare, police and law enforcement, infrastructure, government administration and other services. For each category, a formula was constructed to determine the expenditure needs of the province. The variables used in these formulas are the most important determinants of the expenditure and are those for which data are readily available.

The variables used to determine the needs under the seven categories are:

Education: population, average number of years of education

Health: population, average life expectancy

Social welfare: population, percentage of population over age 65, urban unemployment rate

Police and law enforcement: population, percentage of urban population

Infrastructure: length of roads, area

Government administration: population

Other services: population

Determining the fiscal need of each province involves three steps:

Step 1: determining the share of each spending category in total spending. The share of each expenditure category in total expenditure is calculated using the actual spending figures in 1994 (Table A11.2):

Table A11.1: Fiscal Revenues, Expenditures, and Estimated Fiscal Capacities

	Actual revenue (Mil. Y) 1994	Tax effort (Rev/GDP) 1994	Actual expndt. (Mil. Y) 1994	Actual transfer (Mil. Y) 1994	Estimated fiscal capacity 1994
All China	231159	5.1	392962	11803	228596
Beijing	4585	4.2	9853	5268	9055
Tianjin	5015	6.9	7232	2217	4563
Hebei	9522	4.4	16084	6562	9396
Shanxi	5382	6.3	8923	3541	4562
Inner Mongolia	3630	5.3	9282	5652	3188
Liaoning	15367	5.9	22358	6991	12657
Jilin	5127	5.3	10459	5332	5213
Heilongjiang	8466	5.2	14240	5774	9368
Shanghai	16962	8.6	19084	2122	14323
Jiangsu	13662	3.4	20017	6355	17909
Zhejiang	9463	3.5	15303	5840	13422
Anhui	5468	3.7	9327	3859	6263
Fujian	9194	5.5	13773	4579	6868
Jiangxi	4929	4.8	9203	4274	4175
Shandong	13466	3.5	21877	8411	16734
Henan	9335	4.2	16962	7627	9989
Hubei	7746	4.1	13720	5974	9679
Hunan	8589	5.1	15149	6560	8103
Guangdong	29870	7.0	41683	11813	24621
Guangxi	6226	5.0	12493	6267	5423
Hainan	2753	8.3	4001	1248	1008
Sichuan	13599	4.9	23739	10140	12181
Guizhou	3124	6.0	7423	4299	2325
Yunnan	7670	7.9	20373	12703	7631
Tibet	554	12.1	3030	2476	196
Shaanxi	4259	5.0	8552	4293	3670
Gansu	2908	6.4	7238	4330	2536
Qinghai	701	5.1	2536	1835	583
Ningxia	717	5.4	1938	1221	603
Xinjiang	2870	4.3	7110	4240	2352

Source: Tables A11.1 (a) and (b), and author's own calculations.

Table A11.1(a): China: Basic Indicators by Province

	Population 1994 (Mil.)	GDP per capita 1994 (Th. Y)	Area population (%) (Th. Mu)	Aged 1987	Urban unemployment rate 1994
All China	1198.50	3.76	9590.09	6.23	2.8
Beijing	11.25	9.64	16.80	7.66	0.4
Tianjin	9.35	7.76	11.31	7.79	1.2
Hebei	63.88	3.36	187.95	6.34	2.8
Shanxi	30.45	2.80	156.30	5.98	1.2
Inner Mongolia	22.60	3.02	1192.04	4.26	3.7
Liaoning	40.67	6.35	146.15	6.54	2.5
Jilin	25.74	3.76	186.81	5.56	1.8
Heilongjiang	36.72	4.41	451.47	4.17	2.5
Shanghai	13.56	14.54	6.30	11.52	2.8
Jiangsu	70.21	5.78	102.52	8.23	2.1
Zhejiang	42.94	6.21	101.77	8.20	3.1
Anhui	59.55	2.50	139.06	6.35	3.1
Fujian	31.83	5.29	121.12	6.17	2.4
Jiangxi	40.15	2.57	166.86	5.39	2
Shandong	86.71	4.47	156.57	6.72	3.1
Henan	90.27	2.44	167.01	6.33	2.3
Hubei	57.19	3.29	186.10	6.14	3
Hunan	63.55	2.67	212.10	6.43	3.8
Guangdong	66.89	6.34	177.99	7.28	2.4
Guangxi	44.93	2.76	237.34	6.20	3.6
Hainan	7.11	4.66	33.98	6.36	3.6
Sichuan	112.14	2.48	570.31	6.79	3.8
Guizhou	34.58	1.51	176.04	4.95	5.5
Yunnan	39.39	2.47	393.33	5.70	2.7
Tibet	2.36	1.94	1220.01	6.67	5
Shaanxi	34.81	2.43	205.52	5.26	3.5
Gansu	23.78	1.90	456.55	4.62	5.3
Qinghai	4.74	2.92	742.82	3.93	6
Ningxia	5.04	2.66	51.73	3.69	5.3
Xinjiang	16.32	4.13	1683.98	4.62	3.2

Source: State Statistical Bureau (1995). Cost data are from Wu Renhong, 1995, "China's Inflation and Regional Disparity," and World Bank, 1994, China: Internal Market and Regulations. Social indicators are from Yasuko Hayase and Seiko Kawamata, 1991, Population Policy and Vital Statistics in China, Institute of Developing Economies, Tokyo, Japan. Author's own calculation.

Table A11.1(b): China: Basic Indicators by Province

	Urban Population (%) 1994	Length of roads (kms) 1994	Average years of life education 1987	Average expectancy 1987	Wage& cost index 1992
All China	23.6	1117821	5.68	70.59	1
Beijing	66.6	11532	8.12	74.93	1.19
Tianjin	57.7	4156	7.42	73.64	1.02
Hebei	16.5	50496	5.90	73.26	0.98
Shanxi	25.8	32693	6.29	69.77	0.81
Inner Mongolia	37.0	44202	6.19	69.24	0.82
Liaoning	45.2	42763	7.00	73.32	0.93
Jilin	43.9	29581	6.69	70.11	0.87
Heilongjiang	49.7	48356	6.55	70.33	0.82
Shanghai	70.5	3721	7.92	75.97	1.29
Jiangsu	23.9	25891	5.91	73.63	1.04
Zhejiang	16.5	33170	5.82	71.82	1.21
Anhui	17.2	30876	4.71	71.21	0.87
Fujian	18.3	44608	5.12	70.90	1.19
Jiangxi	20.9	34556	5.15	68.10	0.86
Shandong	17.4	50225	5.52	72.88	0.90
Henan	14.8	47704	5.43	71.68	0.83
Hubei	29.0	48349	5.92	68.91	0.94
Hunan	16.5	58803	6.00	68.82	1.01
Guangdong	16.1	75716	5.96	73.83	1.57
Guangxi	14.1	39550	5.54	70.81	1.07
Hainan	34.1	13015	5.84	69.76	1.22
Sichuan	16.3	100002	5.40	68.70	0.90
Guizhou	15.4	32398	4.37	70.12	0.95
Yunnan	15.9	65578	4.13	64.25	0.94
Tibet	14.1	21842	1.91	63.50	1.17
Shaanxi	21.3	39058	6.29	69.74	0.91
Gansu	18.8	34984	4.40	70.24	0.97
Qinghai	32.6	17061	3.79	66.40	0.90
Ningxia	28.8	8324	5.15	69.74	0.93
Xinjiang	47.7	28611	6.14	69.25	1.00

Source: State Statistical Bureau (1995). Cost data are from Wu Renhong, 1995, "China's Inflation and Regional Disparity," and World Bank, 1994, China: Internal Market and Regulations. Social indicators are from Yasuko Hayase and Seiko Kawamata, 1991, Population Policy and Vital Statistics in China, Institute of Developing Economies, Tokyo, Japan. Author's own calculation.

Table A11.2: Local Expenditures by Category, 1994 (100 Mil Y)

	1994 Actual Amount	Share α
Education, Culture and Related Expenses	83858	0.276
Health, Family Planning and Sports	27467	0.090
Social Welfare	9416	0.031
Government Administration	66539	0.219
Police and Law Enforcement	22000	0.072
Infrastructure Maintenance	23416	0.077
Other services (including subsidies)	71211	0.234
Subtotal	303907	1

Note: Capital expenditures, except for urban maintenance, are excluded. Infrastructure maintenance is named "urban maintenance" in China Almanac of Finance 1995.

Data Source: China Almanac of Finance 1995.

The total fiscal need of 30 provinces in category k (k = education, health, etc.) is the weight (α_k) multiplied by the total fiscal need of all categories. Denoting total local need of all categories by TN, the total fiscal need in category k is

$$TN_k = \alpha_k * TN$$

Step 2: determining the fiscal need of each province in category k. For education (k=E), the fiscal need of province i is calculated using the following formula:

$$N_{iE} = TN_E(P_iE_i/\Sigma_jP_jE_j) = \alpha_E * TN(P_iE_i/\Sigma_jP_jE_j) \quad (4)$$

where N_{iE} is province i's fiscal need for education, α_E=0.276 is the weight assigned to education, TN_E is the 30 provinces' total fiscal need for education, P_i is the population of province i, E_i is the ratio of the national average number of years of education to that in province i, and $P_iE_i/\Sigma_jP_jE_j$ is the share of province i's fiscal need in the 30 provinces' total need for education.

For health (k=H), the fiscal need of province i is calculated using the following formula:

$$N_{iH} = TN_H(P_iL_i/\Sigma_jP_jL_j) = \alpha_H * TN(P_iL_i/\Sigma_jP_jL_j) \quad (5)$$

where N_{iH} is province i's fiscal need for health, α_H=0.090 is the weight assigned to health, TN_H is the 30 provinces' total fiscal need for health, L_i is the ratio of the national average life expectancy to that in province i, $P_iL_i/\Sigma_jP_jL_j$ is the share of province i's fiscal need in the 30 provinces' total need for health.

For social welfare (k=S), the fiscal need of province i is calculated using the following formula:

$$N_{iS} = TN_S(0.5*P_iOLD_i/\Sigma_jP_jOLD_j + 0.5*P_iUMP_i/\Sigma_jP_jUMP_j)$$
$$= \alpha_S*TN(0.5*P_iOLD_i/\Sigma_jP_jOLD_j + 0.5*P_iUMP_i/\Sigma_jP_jUMP_j) \quad (6)$$

where N_{iS} is province i's fiscal need for social welfare, α_S=0.031 is the weight assigned to social welfare, TN_S is the 30 provinces' total fiscal need for social welfare, OLD_i is the ratio of the percentage of elderly population (over age 65) in province i to the national average, UMP_i is the ratio of the urban unemployment rate in province i to the national average, and $0.5*P_iOLD_i/\Sigma_jP_jOLD_j + 0.5*P_iUMP_i/\Sigma_jP_jUMP_j$ is the share of province i's fiscal need in the 30 provinces' total need for social welfare.

For government administration (k=G), the fiscal need of province i is calculated using the following formula:

$$N_{iG} = TN_G(P_i/\Sigma_jP_j) = \alpha_H*TN(P_i/\Sigma_jP_j) \quad (7)$$

where N_{iG} is province i's fiscal need for government administration, α_G=0.219 is the weight assigned to government administration, TN_G is the 30 provinces' total fiscal need for government administration, and P_i/Σ_jP_j is the share of province i's fiscal need in the 30 provinces' total need for government administration.

For police and law enforcement (k=P), the fiscal need of province i is calculated using the following formula:

$$N_{iP} = TN_P(P_iL_i/\Sigma_jP_jL_j) = \alpha_P*TN(P_iUB_i/\Sigma_jP_jUB_j) \quad (8)$$

where N_{iP} is province i's fiscal need for police and law enforcement, α_P=0.072 is the weight assigned to police and law enforcement, TN_P is the 30 provinces' total fiscal need for police and law enforcement, UB_i is the ratio of percentage of urban population in this province to the national average, and $P_iUB_i/\Sigma_jP_jUB_j$ is the share of province i's fiscal need in the 30 provinces' total need for police and law enforcement.

For infrastructure (k=I), the fiscal need of province i is calculated using the following formula:

$$N_{iI} = TN_I(0.5*LR_i/\Sigma LR_j + 0.5*A_i/\Sigma_jA_j) = \alpha_I*TN(0.5*LR_i/\Sigma LR_j + 0.5*A_i/\Sigma_jA_j) \quad (9)$$

where N_{iI} is province i's fiscal need for infrastructure, α_G=0.077 is the weight assigned to infrastructure, and TN_I is the 30 provinces' total fiscal need for infrastructure. LR_i is the total length of roads in province i, and A_i is the area of province i. The former reflects the need for maintenance, and the latter reflects the cost due to sparsity of population. $0.5*LR_i/\Sigma LR_j + 0.5*A_i/\Sigma_jA_j$ is the share of province i's fiscal need in the 30 provinces' total need for infrastructure.

For other services (k=O), the fiscal need of province i is calculated using the following formula:

$$N_{iO} = TN_O(P_i/\Sigma_jP_j) = \alpha_O*TN(P_i/\Sigma_jP_j) \quad (10)$$

where N_{iO} is province i's fiscal need for other services, α_O=0.234 is the weight assigned to other services, TN_O is the 30 provinces' total fiscal need for other services, and P_i/Σ_jP_j is the share of province i's fiscal need in the 30 provinces' total need for other services.

Step 3: summing up province i's needs in the seven categories to get the total fiscal need of the province:

$$N_i = \alpha_E(P_iE_i/\Sigma_jP_jE_j) + \alpha_H(P_iL_i/\Sigma_jP_jL_j) + \alpha_S(0.5*P_iOLD_i/\Sigma_jP_jOLD_j + 0.5*P_iUMP_i/\Sigma_jP_jUMP_j) + \alpha_G(P_i/\Sigma_jP_j) + \alpha_P(P_iUB_i/\Sigma P_jUB_j) + \alpha_I(0.5*LR_i/\Sigma LR_j + 0.5*A_i/\Sigma_jA_j) + \alpha_O(P_i/\Sigma_jP_j) \quad (11)$$

where N_i is the total fiscal need of province i.

Equation (11) can be rewritten as follows by combining some terms:

$$N_i = \alpha_E(P_iE_i/\Sigma_jP_jE_j) + \alpha_H(P_iL_i/\Sigma_jP_jL_j) + \alpha_S(0.5*P_iOLD_i/\Sigma_jP_jOLD_j + 0.5*P_iUMP_i/\Sigma_jP_jUMP_j) + \alpha_P(P_iUB_i/\Sigma P_jUB_j) + \alpha_I(0.5*LR_i/\Sigma LR_j + 0.5*A_i/\Sigma_jA_j) + (\alpha_G+\alpha_O)(P_i/\Sigma_jP_j)$$

$$= 0.276(P_iE_i/\Sigma_jP_jE_j) + 0.090(P_iL_i/\Sigma_jP_jL_j) + 0.31(0.5*P_iOLD_i/\Sigma_jP_jOLD_j + 0.5*P_iUMP_i/\Sigma_jP_jUMP_j) + 0.072(P_iUB_i/\Sigma P_jUB_j) + 0.077(0.5*LR_i/\Sigma LR_j + 0.5*A_i/\Sigma_jA_j) + 0.453(P_i/\Sigma_jP_j) \quad (12)$$

Step 4: adjusting for cost differentials across provinces. The above calculation has not considered the cost differentials across provinces in providing the same level of public services. With limited data, a wage-and-cost index was constructed, using prices of food and construction materials and wage levels. Each of the first two commodities is given a weight of 0.25, and the wage level is given a weight of 0.5. There is obviously much room for improvement, but the present data are sufficient to serve as an illustrative example.

The wage-and-cost index is fixed at 1 for the national average. If a province's index is higher than 1, it means the unit cost of providing public services there is higher than the national average, and vice versa. The index figures are shown in Table A-1(b).

The cost adjusted fiscal need of province i is:

$$AN_i = WCI_iN_i \quad (13)$$

where AN_i is the cost adjusted fiscal need of province i, WCI_i is the wage-and-cost index of province i, and N_i is the fiscal need calculated using equation (12).

Transfers to the Provinces

Using two different definitions of "needs", the transfers to the provinces are different. If the fiscal need figures (unadjusted for cost differentials) are used, the transfer from the center to province iis:

$$T_i = N_i - C_i$$

where N_i is given by equation (12). If the cost adjusted fiscal need figures are used, the transfer from the center to province i is:

$$T_i = AN_i - C_i$$

where AN_i is given by equation (13). Transfers calculated using these formulas are presented in Table A11.3. For comparison, the actual transfers in 1994 are also presented in Table A11.3.

The above calculations assume that 100 percent of the central government transfers made in 1994 be allocated according to the proposed equalization formula. In other words, the proposed system is a "full" equalization system. However, the distribution of transfers under this system is distinctly different from the actual allocation in 1994: the standard deviation (the average difference between the proposed per capita transfer and the actual per capita transfer) is 263 Yuan, or 198 percent of the average per capita transfer in 1994 (See Table A-4). Obviously, such a drastic reallocation of resources is politically infeasible. Two alternative "partial" equalization schemes were, therefore tried:

(1) 50 percent equalization. 50 percent equalization means that 50 percent of the actual central government transfers (net) made to the localities in 1994 are allocated in proportion to the original allocation and the other 50 percent are allocated by the proposed equalization formula using cost adjusted figures. From Table A11.4, one can see that under this system the standard deviation from the actual allocation now becomes 132 Yuan or 98 percent of the average per capital transfer in 1994.

(2) 20 percent equalization. 20 percent equalization means that 80 percent of the actual central government transfers (net) made to the localities in 1994 are allocated in proportion to the original allocation and the other 20 percent are allocated by the proposed equalization formula using cost adjusted figures. From Table A11.4, one can see that under this system the standard deviation from the actual allocation now becomes 53 Yuan or 39 percent of the average per capital transfer in 1994.

Does the Transfer System Equalize?

The transfer system designed above aims to equalize the provinces' abilities to provide public services at similar levels of tax effort. While equalizing per capita income is not the direct objective, due to a high correlation between income and fiscal capacity, a transfer system like the one suggested above should also have strong redistributive effects on per capita income.

Table A11.3: Fiscal Needs and Fiscal Transfers

	Unadjusted for cost differentials			Adjusted for cost differentials			
	Fiscal need (Mil. Y)	Formula transfer (Mil. Y)	Per capita formula transfer (Y)	Fiscal need (Mil. Y)	Formula transfer (Mil. Y)	Per capita formula transfer (Y)	Actual per cap transfer (Y)
All China	392962	161803	135.0	387677	161803	135.0	135.0
Beijing	3735	-5238	-465.6	447	-4687	-416.6	468.3
Tianjin	3014	-1525	-163.1	3086	1502	160.6	237.1
Hebei	19585	10030	157.0	19315	10089	157.9	102.7
Shanxi	9640	4998	164.2	7833	3327	109.3	116.3
Inner Mongolia	9513	6226	275.5	7809	4700	208.0	250.1
Liaoning	13300	633	15.6	12381	-281	-6.9	171.9
Jilin	8634	3368	130.8	7528	2354	91.5	207.1
Heilongjiang	12982	3557	-96.9	10688	1343	36.6	157.2
Shanghai	4513	-9657	712.2	5825	8644	-637.5	156.5
Jiangsu	21493	3529	50.3	22367	4535	64.6	90.5
Zhejiang	13285	-135	-3.1	16199	2825	65.8	136.0
Anhui	19400	12933	217.2	16936	10857	182.3	64.8
Fujian	10550	3625	113.9	12613	5843	183.6	143.9
Jiangxi	13114	8799	219.2	11341	7288	181.5	106.5
Shandong	26869	9977	115.1	24199	7593	87.6	97.0
Henan	27687	17421	193.0	23007	13240	146.7	84.5
Hubei	18444	8628	150.9	17340	7792	136.2	104.5
Hunan	19790	11505	181.0	20149	12253	192.8	103.2
Guangdong	20700	-3860	-57.7	32586	8101	121.1	176.6
Guangxi	14243	8683	193.2	15363	10110	225.0	139.5
Hainan	2459	1427	200.8	3021	2047	287.9	175.5
Sichuan	36252	23695	211.3	32657	20826	185.7	90.4
Guizhou	11963	9487	274.3	11436	9267	268.0	124.3
Yunnan	14559	6820	173.1	13794	6269	159.1	322.5
Tibet	3374	3129	1325.7	3961	3830	1622.8	1049.2
Shaanxi	11045	7260	208.6	10129	6569	188.7	123.3
Gansu	8987	6350	267.1	8737	6307	265.2	182.1
Qinghai	3139	2516	530.8	2850	2306	486.5	387.1
Ningxia	1810	1188	235.7	1683	1099	218.0	242.3
Xinjiang	8321	5876	360.1	8396	6148	376.7	259.8

Source: Tables A11.1 (a) and (b), and author's own calculations.

Table A11.4: Fiscal Transfers under Alternative Equalization Schemes (Yuan)

	100% Equalization		50% Equalization		20% Equalization		Actual per cap transfer 1994
	Per cap transfer	Differ. from act. amt.	Per cap transfer	Differ. from act. amt.	Per cap transfer	Differ. from act. amt.	
All China	135.0	0.0	135.0	0.0	135.0	0.0	135.0
Beijing	416.6	-884.9	25.8	-442.4	291.3	-177.0	468.3
Tianjin	-160.6	- 397.7	38.2	-198.9	157.6	-79.5	237.1
Hebei	157.9	55.2	130.3	27.6	113.8	11.0	102.7
Shanxi	109.3	- 7.0	112.8	-3.5	114.9	-1.4	116.3
Inner Mongolia	208.0	-42.1	229.0	-21.1	241.7	-8.4	250.1
Liaoning	-6.9	-178.8	82.5	-89.4	136.1	-35.8	171.9
Jilin	91.5	-115.7	149.3	-57.8	184.0	-23.1	207.1
Heilongjiang	36.6	-120.7	96.9	-60.3	133.1	-24.1	157.2
Shanghai	-637.5	-793.9	-240.5	-397.0	-2.3	-158.8	156.5
Jiangsu	64.6	-25.9	77.6	-13.0	85.3	-5.2	90.5
Zhejiang	65.8	-70.2	100.9	-35.1	122.0	-14.0	136.0
Anhui	182.3	117.5	123.6	58.8	88.3	23.5	64.8
Fujian	183.6	39.7	163.7	19.8	151.8	7.9	143.9
Jiangxi	181.5	75.1	144.0	37.5	121.5	15.0	106.5
Shandong	87.6	-9.4	92.3	-4.7	95.1	-1.9	97.0
Henan	146.7	62.2	115.6	31.1	96.9	12.4	84.5
Hubei	136.2	31.8	120.4	15.9	110.8	6.4	104.5
Hunan	192.8	89.6	148.0	44.8	121.1	17.9	103.2
Guangdong	121.1	-55.5	148.9	-27.7	165.5	-11.1	176.6
Guangxi	225.0	85.5	182.3	42.8	156.6	17.1	139.5
Hainan	287.9	112.4	231.7	56.2	198.0	22.5	175.5
Sichuan	185.7	95.3	138.1	47.6	109.5	19.1	90.4
Guizhou	268.0	143.7	196.2	71.8	153.1	28.7	124.3
Yunnan	159.1	-163.4	240.8	-81.7	289.8	-32.7	322.5
Tibet	1622.8	573.7	1336.0	286.8	1163.9	114.7	1049.2
Shaanxi	188.7	65.4	156.0	32.7	136.4	13.1	123.3
Gansu	265.2	83.1	223.6	41.6	198.7	16.6	182.1
Qinghai	486.5	99.4	436.8	49.7	407.0	19.9	387.1
Ningxia	218.0	-24.2	230.1	-12.1	237.4	-4.8	242.3
Xinjiang	376.7	116.9	318.3	58.4	283.2	23.4	259.8
SD		263.5		131.8		52.7	
C.O.V.		1.95		0.98		0.39	

Note: 100 percent equalization means that 100 percent of the actual central government transfers (net) made to the localities in 1994 are allocated by the proposed equalization formula using cost adjusted fiscal need measurements.50 percent equalization means that 50 percent of the actual central government transfers (net) made to the localities in 1994 are allocated in proportion to the original allocation and the other 50 percent are allocated by the proposed equalization formula using cost adjusted figures. 20 percent equalization means that 80 percent of the actual central government transfers (net) made to the localities in 1994 are allocated in proportion to the original allocation and the other 20 percent are allocated by the proposed equalization formula using cost adjusted figures. SD: standard deviation; C.O.V.: coefficient of variations.

The following regression is conducted to test the hypothesis that a transfer system equalizes per capita income across provinces :

$$PCT_i = a_0 + a_1 \, PCGDP_i$$

where PCT_i is the per capita transfer to province i, and $PCGDP_i$ is the per capita GDP of province i. If a_1 is negative and statistically significant, it means that the system has a significant equalization effect.

When per capita transfers are calculated using need figures unadjusted for cost differentials, a_1 is significantly negative. At the same time, the R-square is 0.55, implying that 55 percent of the variations of the transfers across provinces serves the purpose of "equalization." This indicates a significant redistributive effect of the proposed transfer system. The regression results are as follows:

Regression III: $PCT_i = 544.26 - 91.26 \, PCGDP_i$
(2.55) (-14.51)
R-square = 0.59, No. of observations = 30, Degrees of freedom =28.

When per capita transfers are calculated using needs figures adjusted for cost differentials, a_1 is also significantly negative. The R-square is 0.42, showing a slightly weaker correlation between the two indices than that in Regression III. The regression results are as follows:

Regression IV: $PCT_i = 518.77 - 83.93 \, PCGDP_i$
(1.93) (-4.54)
R-square = 0.42, No. of observations = 30, Degrees of freedom =28.

For comparison purposes, the actual transfer figures in 1994 were used to run the same regression. The resulting a_1 is statistically insignificant and the R-square is only 0.0002, showing not even a slight correlation between per capita transfers and per capita GDP levels. This suggests that the current transfer system has not effectively achieved any redistributive goal. The regression results are as follows:

Regression V: $PCT_i = 206.46 - 0.97 \, PCGDP_i$
(1.10) (-0.075)
R-square = 0.0002, No. of observations = 30, Degrees of freedom =28.

The same regression is also conducted using the per capita transfer figures generated by the "partial equalization" transfer schemes proposed in the previous section. Table A11.5 compares the regression results of four systems: actual transfers in 1994, 20 percent equalization, 50 percent equalization, and full equalization. The results show that the full equalization and 50 percent equalization schemes have statistically significant equalization effect (the slope coefficients are significantly negative). The 20 percent equalization schemes do have some equalization effect (the slope coefficient is negative), but it is not statistically significant. The actual transfer scheme has the least equalization effect (the slope coefficient is almost zero).

Table A11.5: Regression Results under Four Transfer Schemes: $PCT_i = a_0 + a_1 PCGDP_i$

	1994 Actual Transfer	20% Equalization	50% Equalization	100% Equalization
a_0	206.46	268.92	362.62	518.77
	(1.10)	(1.36)	(1.66)*	(1.93)*
a_1	-0.97	-17.4	-41.95	-83.93
	(0.075)	(-1.30)	(-2.81)*	(-4.54)*
R_2	0.00	0.06	0.22	0.42
DF	28	28	28	28

Note: The calculations use cost adjusted figures on fiscal needs. Numbers in parentheses are t ratios. A "*" indicates that the t ratio is statistically significant.

Conclusions

Statistical evidence suggests that China's current fiscal transfer system perform almost no redistributive function. The illustrative example of a formula-based equalization transfer model presented in this Annex shows that an important improvement in redistribution can be made by introducing appropriate measures of fiscal capacities and needs with appropriate variables. One should notice that shifting from the current transfer system to a "full equalization" system might not be feasible in the short- or medium run. A pragmatic approach is to increase the magnitude of the new transfer scheme gradually over time in order to minimize political difficulties. The purpose of this illustrative example is not to provide the exact model that China is to use; the intent is to offer an alternative methodology to the ones that are being considered.

ANNEX 12:
FINANCIAL MANAGEMENT INFORMATION SYSTEMS

Information is the lifeblood of budgetary, resource allocation and financial management. Financial management information systems (FMIS) provide decision-makers and public sector managers with a set of tools to support:

1. Controlling aggregate spending and the deficit;
2. Strategic prioritization of expenditures across policies, programs and projects for allocative efficiency and equity;
3. Better use of budgeted resources, i.e.; to achieve outcomes and produce outputs at the lowest possible cost.

China's budgetary reforms will need to pay attention to further developing information systems. Much of the recommendations made in the report cannot be implemented without sufficient information to support budgetary decisions and implementation monitoring. China is still at the start of developing the kind of information system that is discussed in this annex. Developing of such a system will take considerable time and resources, but should be taken serious, if budget management is to be improved.

Improving systems and processes requires an understanding of how these three levels interact. Particular attention needs to be given to the capacity to link the three levels through a set of commonly shared databases. There is a need for vertical integration–through the planning, budgeting and financial management cycle–and horizontal integration–accounting, budgeting, cash management and audit. This annex discusses approaches to this integration.

Traditionally, control has been the dominant, if not the single, reason for developing FMIS'. This control role will always be central. However, to deliver on the three levels of performance, a FMIS that supports a result orientation at the strategic and operational level will be needed. Financial data that supports informed decisions on policies and programs and that link information on costs, outputs and outcomes will be essential. The trend to decentralize within and between levels of government also underscores the importance of adequate FMIS.

This annex is not advocating a big bang theory of FMIS. A modular approach will often be appropriate. Most of the elements of a comprehensive system exist in some form in every country. The nature and pace of integration of these elements will vary from country to country, but each step must take into account the end point–timely and reliable information for use throughout the resource allocation, budgeting and financial management cycle. Some countries may be in a position to take advantage of developments in information technology to move relatively quickly from a currently disabled, manual system to an automated, integrated system. Automation will not, however, resolve problems associated with structure and a lack of discipline on the part of decision-makers.

FMIS INADEQUACIES

Inadequacies in FMIS show up in all aspects of budgeting, resource allocation and financial management. From the perspective of the three levels, the most obvious symptoms of inadequate systems are:

1. At the macro level, assessment of the fiscal situation is derived from the books of the central bank;
2. At the strategic level, there is no costing information on policies and programs;
3. At the operational level, financial information is not available on time or in a form that facilitates effective expenditure control or management of agencies, programs or projects.

More generally, the symptoms include a lack of timely and appropriate financial information for decision making during planning and budget formulation; lack of timely and accurate financial management information during budget execution; and non-existent, or out-of-date, financial reporting.

Some of the factors underlying these inadequacies include:

- Gaps in the legal framework
- Lack of a standard classification coding structure
- Poorly specified reporting requirements–external and internal
- Multiple ex ante controls on expenditure
- Multiple FMIS, often computer based, across government that do not communicate with each other
- An inability to move data from one stage in the budgetary cycle to the next.

INSTITUTION BUILDING AND POLICY REFORMS

Implementing and improving information systems should be seen in the context of wider institution building and policy reform efforts. FMIS influence, and are influenced by, an overall regulatory framework that consists of:

a. The control structure that governs the use of government funds and are derived from the legislative framework;
b. Accounts classification, which enables consistent recording of each financial transaction for expenditure control, costing, and economic and statistical analysis; and,
c. Reporting requirements covering: (a) external reporting–to provide information to the legislature and the public, as well as to other countries, international organizations, overseas investors and financial markets; and, (b) internal management reporting for government policy makers and managers.

Computerization is a key issue linked to any consideration of FMIS. As a minimum, the adequacy of the regulatory framework will need to be reviewed, and modified as appropriate, and the institutional capacities of the responsible government agencies analyzed–inadequacies highlighted and corrective measures identified–before computer systems can be designed to support fiscal management. The benefits realized from computer systems will depend on the degree of success achieved in strengthening basic

functional processes, the regulatory framework and the organizational structures responsible for them. Computerization is discussed later in this Annex.

DEVELOPING A CORE SYSTEM

The central premise of this annex is that the broad technical requirements of government budgeting and accounting are similar for all countries, and a core system can be specified to meet these requirements. Such a system would meet basic needs for most countries, but aspects would need to be tailored to suit particular needs. The rate of implementation would depend on the capacity of individual countries. Better integration of the subsystems is the ultimate objective, so it is important to build in this capacity from the outset.

Many countries could start with a core accounting system that consists of modules for accounts payable, accounts receivable and the general ledger. An automated accounting system would ensure completeness of data capture. No transaction would be processed outside the system, and rigorous financial controls would be applied to all transactions processed by the system. With the core accounting system as a foundation, government could then expand the system as capacity developed.

Developing a system involves: (a) analyzing business processes involved in fiscal management; (b) defining a general information architecture, which is derived by an analysis of the strength of information linkages among the business processes; and (c) defining a general system architecture, based on the information architecture. The general system architecture can be used for the design and development of application software, or for the selection of existing software packages that meet requirements.

The functional processes carried out by the central government in the areas of budgeting and accounting–and linkages to the control framework–are illustrated in Figure A12.1. As indicated, the functional processes can be categorized as those carried out by the central agencies and those carried out by the spending ministries and agencies. Those of the former group are most directly linked to the control framework. Indeed, one of the main functions of the central agencies is to ensure that the control framework is properly applied throughout government.

Figure A12.2 shows the core elements of the information system network required to support government fiscal management and the main information flows between these elements. Analyzing data from a number of countries on fiscal management (FM) processes has derived this information architecture and the information systems supporting these processes. The Y-axis lists the main processes in FM, the X-axis the organizations normally responsible for these processes. Each box lies at the intersection of the functional process and the organization(s) normally responsible for the process and is the information support system for that process. Each system could comprise a number of subsystems. Figure A12.2 also shows the main information flows between the system modules.

FM support at macro, strategic and operational levels

Macroeconomic forecasting. The MOF, the Planning Organization, and the Central Bank normally use this group of systems to support the setting of fiscal policy. The systems assist with macro fiscal planning and the development of the macroeconomic framework. This is in turn used by the MOF to set aggregate budget parameters and guidelines for budget agencies to submit estimates. These systems require data from external economic databases and the assumptions regarding GNP, inflation rates and the deficit.

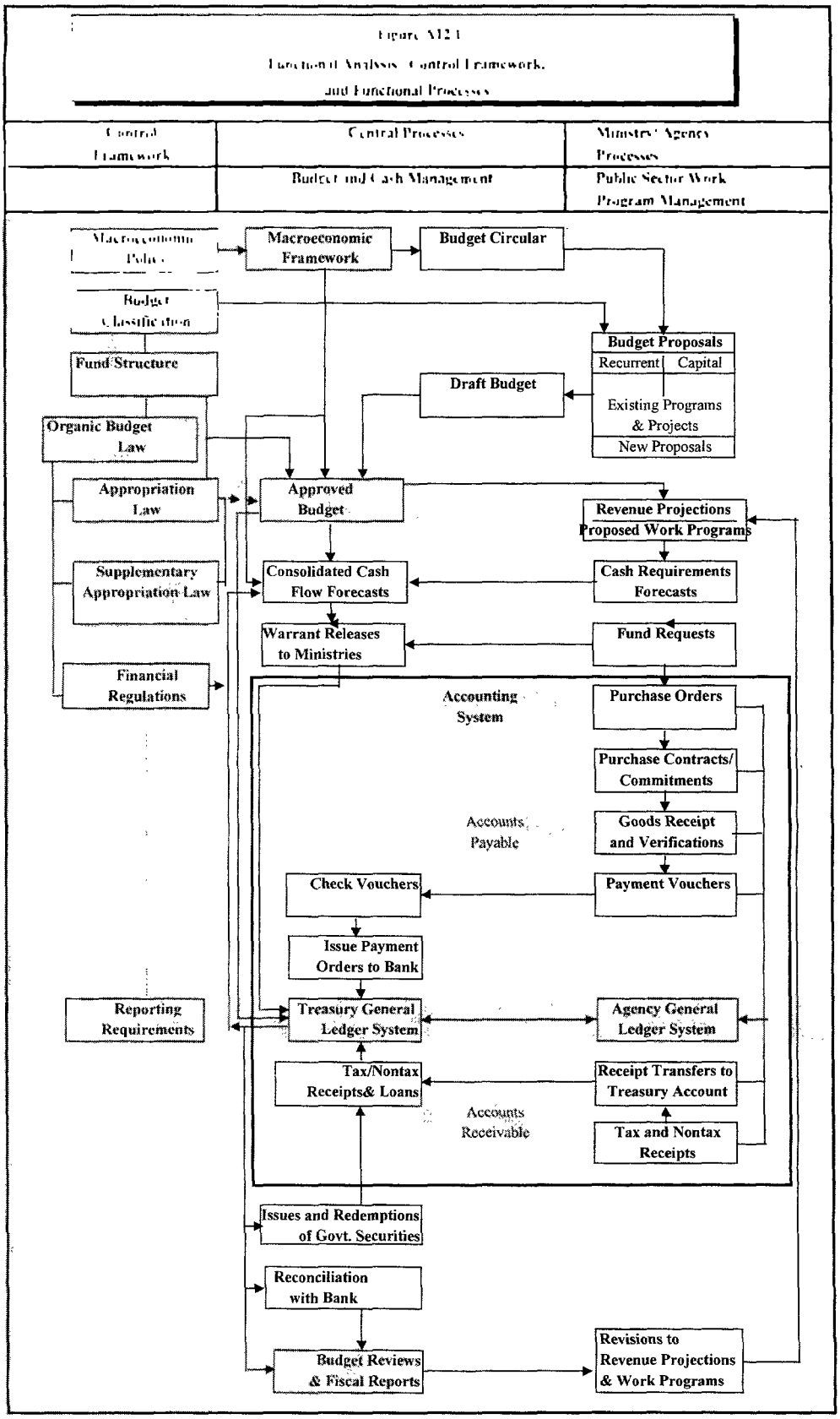
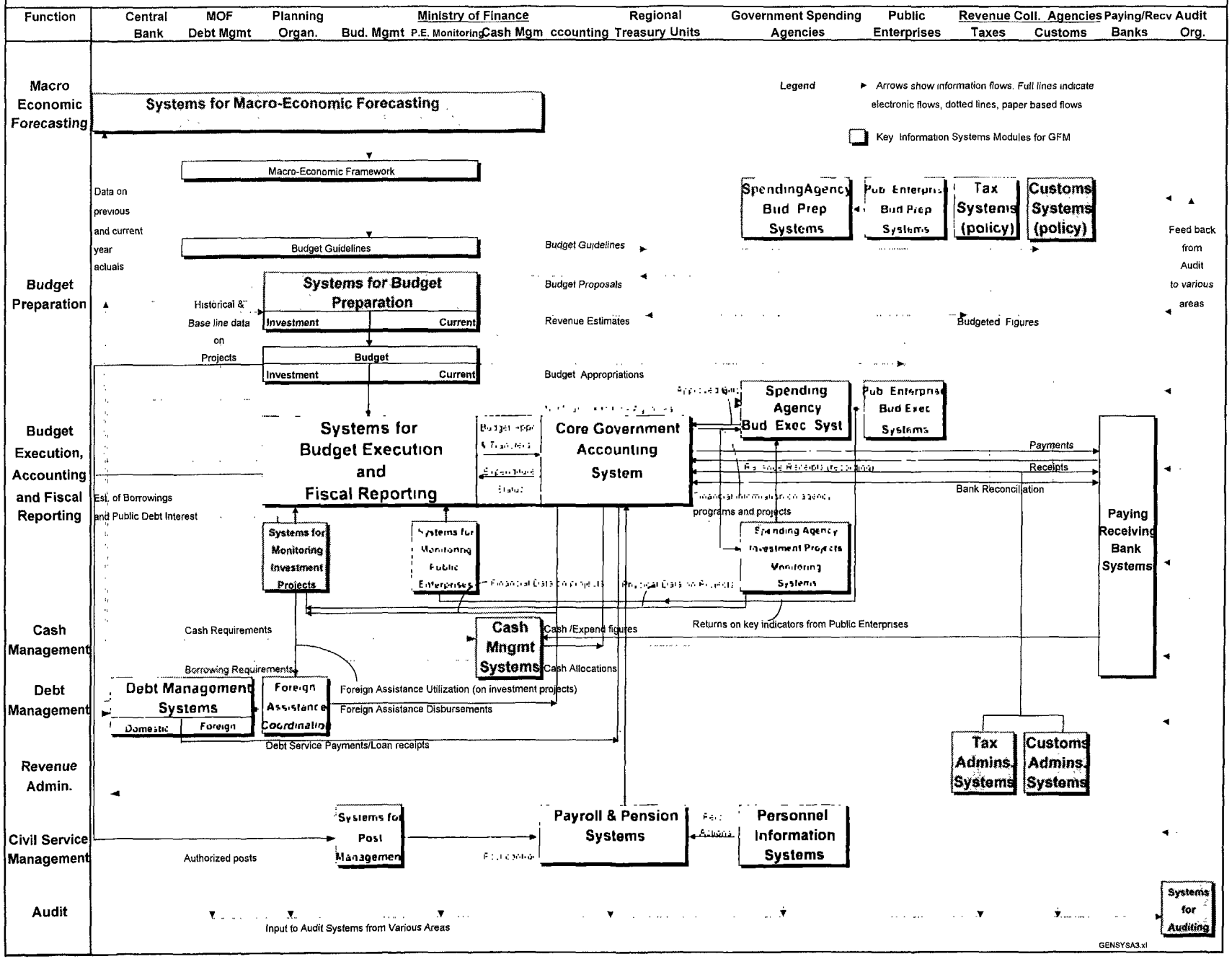


Figure A12.1
Functional Analysis: Control Framework, and Functional Processes

Figure A12.2: Information Systems Architecture for Government Fiscal Management



Additionally, they require information on programs and projects the government intends to implement over the period of the program such as data on tax and non-tax revenues, and data on domestic and external borrowings, which are maintained by other components of the FMIS network.

Budget Preparation and Approval. These information systems support strategic priority setting by assisting with the preparation of budget estimates. The systems receive details of ongoing and planned programs and projects from line agencies, consolidate them and produce from them the documents that form the basis of the negotiations between the line agencies and the MOF. After finalization of the budget, the systems produce the approved budget estimates.

The systems should be able to capture and maintain the budgetary proposals and income estimates of all government agencies and to capture subsequent changes during the budget preparation, approval and amendment processes. The evaluation of the budget proposals include an examination of the manpower component, maintenance and other operating expenses, and the evaluation of the capital outlays program, using baseline data from previous periods for comparison. Examination of the capital budget requires data on the physical and financial status of government-approved projects, both locally and foreign funded. The system should be able to access and generate the baseline data from the relevant past-year databases.

Budget execution, core accounting and fiscal reporting. These systems support operations and are the primary repository of financial data that serve as the basis of the government's FMIS. These systems perform basic accounting functions, processes for budget execution, monitoring and control, and provide the information required for cash management and to implement cash limits in order to obtain the status of actual expenditures on ongoing projects. These systems also monitor and evaluate the overall budget implementation processes and produce the necessary fiscal reports.

In addition, these systems would provide useful financial information to the line ministries and spending units to enable them to better manage their work programs. These systems need to be comprehensive in coverage and be a source of reliable and timely data to become a credible source of information for users.

These systems maintain data on:

a. approved (capital and recurrent) budgeted appropriations,
b. sources of financing for programs and projects,
c. budget transfers,
d. supplementary allocations,
e. fund releases (warrants) against budgetary allocations over the course of the year, and
f. data on commitments and actual expenditures against budgeted allocations.

The budget execution systems normally operate at two levels–at the line agencies and at the MOF. The line agencies' systems, operated by their finance departments, enable managers to track the budget implementation process and implement expenditure controls at the agency level. The central systems track the budget execution process for the government as a whole.

At the start of the fiscal year, the legislature-approved budget is entered into the system. Budget transfers such as supplementary authorizations and warrants are also entered during the year they are issued. As commitment and expenditure transactions take place at the line agencies, these systems: (a) check for budget authorization and the existence of a prior commitment, (b) record information verifying receipt of

goods, (c) authorize payment, and (d) update the total amounts committed and spent. They operate on the basis of commitment, verification and payment request transactions received from the line agencies, either electronically or on paper.

Subsystems. There are a number of subsidiary systems that are essential to a well-performing public sector.

Subsidiary Payment Systems. These systems cater to payments such as payroll and pension. The systems post summaries to and interface with the core accounting system.

Cash Management System. This system maintains an up-to-date picture of the government's liquidity position and cash requirements. This system obtains information on actual agency expenditures and cash balances in government (including agency) accounts from the general ledger, revenue inflows, borrowing, loan disbursements, treasury bills, government bonds and cash deposit maturities. This information is obtained either from the general ledger or from the systems for these areas, e.g., the debt management system. Government can use this information to decide on: (a) budget ceilings and fund releases to line agencies; and (b) the timing of the issues and redemption of government securities to provide short-term financing for shortfalls.

Debt Management System. This system maintains information on public domestic and external borrowings. This includes information contained in loan documents and transactions and issues of government securities. In addition to accounting information, these systems also provide important information required in the formulation of fiscal policy such as forecasts of draw-down and debt-servicing liabilities and debt implications of fiscal and deficit financing policies.

Civil service management systems. This system assists in aspects of civil service management that are relevant to financial management (FM). These are processes associated with post management and payroll and pension payments. The corresponding system modules therefore form important elements in the FMIS network.

Revenue Administration. This group of systems assist the government in: (a) the processes for the formulation of tax and tariff policies, and (b) the collection of tax and non-tax revenue. The tax revenue administration system provides summary information on revenue collections to the core accounting systems.

Auditing. These systems assist the internal and external audit functions. Auditing takes place at two levels: internal audit at the line ministries during the course of the FY and external audit by the auditor general through random checks and on the final accounts for the FY.

INTEGRATING INFORMATION SYSTEMS

Integration of the different elements of the FMIS network will not happen without conscious effort and the involvement of all stakeholders. More often than not, information systems are implemented as components of separate projects, responding to specific needs, with little thought given to requirements in other areas and or to critical interrelationships. The resulting information systems are often disparate and segmented with little or no capacity for sharing data. These systems have overlapping and sometimes conflicting functions and provide incomplete coverage, particularly for managerial information requirements, which normally span several areas.

The failure to integrate financial management information results in:

- fragmented and unreliable data,
- duplication of data difficult to reconcile,
- failure to use actual results in planning and budgeting,
- failure to fully and publicly report financial and operational results, and
- undue emphasis upon one of the component subsystems, usually budgeting, which tends to dominate, duplicate and crowd out the others.

The investments required to set up modern computer-based information systems coveringthe major areas of FMIS are sizable and can span several years. Investments could easily range from US$10 to 50 million over five years. Integration is a requirement, not an option, for these large investments to yield expected benefits. Incompatible or duplicative systems would be wasteful and inefficient and would not provide the information that governments require for economic management.

Components of an IFMS

An integrated financial management system (IFMS) consists of an interrelated set of subsystems that plan, process and report upon resources, quantifying them in financial terms. The basic subsystems normally are accounting, budgeting, cash management, debt management and related internal controls. An important element of modern internal control throughout government is a professional internal audit function that is an integral part of an IFMS.

The factor that "integrates" the system is a set of commonly shared, reliable databasess to and from which all data are expressed in financial terms flows. All of the subsystems and users of financial data must participate in common data sharing. The validation, classification and recording of data in the accounting subsystem produces timely reports of classified data for users. The common database may be manually maintained, but an electronic database is much more flexible and accessible.

An IFMS can be developed regardless of the organizational structure, but it is likely to function better where the four basic subsystems are closely related under a common, professionally qualified financial management executive.

In integrated networks, the component elements are able to exchange information with ease and to share commonly used data. Integrated systems must be structured along functional rather than organizational lines. The system needs to support a functional area across all organizations being integrated. This enables the creation of systems and databases in which the agency responsible for a function provides a subset of data. However, the databases are accessible by relevant core agencies, subject to appropriate security controls. All agencies work with the same set of data, eliminating duplicative data gathering and data inconsistencies.

Framework for integration

The first step towards achieving integration is to develop a framework that provides an overview of the system network required to support FM. The framework is developed by analyzing: (a) basic functional processes and information requirements; (b) responsibilities of agencies in charge of the processes; (c) information flows between the processes, including the nature, volume and frequency of these flows; and (d) data characteristics of the information used and created by the processes. This framework would address questions such as:

a. Which information system modules are required to support FM;
b. What is the scope, scale and type of a particular system component; and,
c. How do these systems interrelate?

The framework would consist of:

a. A system architecture that identifies the major component modules of the network required to support FM, the type of information maintained by each module and the information flows between modules; and
b. A technology architecture that identifies the appropriate technology choices for the hardware and software to set up the modules.

The integration of system modules can be achieved incrementally once the framework has been set up and the prerequisites and criteria for integration have been spelled out and incorporated in the implementation plan. The framework will serve as a road map for implementation.

Automation

Fiscal management processes are transaction intensive. Retrieving information from manual records and reclassifying it in an appropriate format or classification can be extremely time consuming and labor intensive. Automated systems speed up the process and provide the accurate data required for economic and fiscal management.

Three aspects of computer-based information systems are particularly important:

a. The rapid compilation of data on transactions from widespread locations and timely generation of information in formats prescribed by the legislature or for internal control;
b. Ensuring that prescribed controls and procedures are adhered to at the point of origin of a transaction; and
c. The integration of the posting and classification of transactions with the functional process in such a way that performance (e.g., authorizing a payment) simultaneously ensures that all transactions are classified and posted. This in turn will ensure complete and timely data.

Technological recommendations. Three important technological improvements for a well-performing information system are: (a) multi-tiered networks, (b) system portability and scalability, and (c) application-specific technology.

Multi-tiered networks. Several elements of the FMIS network require system modules at the line agency and central levels with facilities for generating, storing, and processing data at each level and for exchanging data between levels. The data volumes encountered can vary widely across the nodes of the network. Government-wide FMIS requires a multi-tiered network. This could consist of stand-alone microcomputers, local area network (LANs) or minicomputers, located at the nodes (MOF, other core agencies, the line agencies and subordinate/regional treasury offices) and connected by telecommunication lines.

Local computers carry out the transaction processing and database management at each node. The summary or detailed data required for the applications are transmitted to the computer in the agency responsible for that system (e.g., to the MOF's budget division for the budget system, to the treasury for the accounting and cash management systems). This configuration is often preferred for two reasons: (a) computing power is distributed commensurate with node requirements, making this system less vulnerable to malfunctions at the central site; and (b) end users at the line agencies have more control of technological and data resources, which inculcates a sense of ownership in the system. In the absence of good telecommunication facilities, the data transfer between the nodes and the center could be periodic (daily, weekly or monthly, depending on the application system) in an off-line/batch node. The size of each node's computers would depend on the amount of data and number of transactions. They could be stand-alone microcomputers, microcomputers connected by a LAN, or fairly large capacity minicomputers at the center and larger line agencies.

Systems portability and scalability. For system modules implemented at multiple levels, the software at each node should be able to be run on small or large computers without major changes. These properties can be achieved by choosing compatible computers that offer multiple size configurations. However, this would restrict additions to the network to this vendor and line of computers. To avoid these restrictions, the application systems should be developed using tools and DBMS portable software that can operate on machines of different sizes offered by several vendors.

To ensure vertical and horizontal portability, and scalability, the hardware should be an open system–assembled from components that conform to generally (though not universally) accepted standards. The hardware and software would therefore be interchangeable, providing greater flexibility. It will be some time before there is a full set of products on the market that truly conforms to open system standards; at present, the UNIX environment comes the closest. Most vendors now offer a version of UNIX. Since UNIX versions vary slightly with the vendor, some application changes may be required before it can be used on a different vendors' machine; however, time and effort involved in making these changes would be small compared to rewriting the applications.

Certain tools such as fourth-generation languages (4GLs), RDBMs and graphic user interfaces make it easy to add or change application features, including changes to data-base structures, associated programs and report formats. The use of these tools increases application

development productivity and, therefore, reduces development time. These tools also enable end users to access the databases and to program simple reports.

Application-specific technological requirements. The technology required for the system modules would depend on the modules' functional characteristics, including the amount of data handled, the size of the data-bases, the number and rates of transactions, and the volume of the information flow between modules. The distribution of information processing, either centrally or among widely separate locations, is important. If distributed among widely separate locations, the following factors should also be taken into account: how frequently the information needs to be aggregated at the center, and the requirements for output facilities such as graphics, report writing and desktop publishing, and for analytical facilities.

Off-the-shelf commercial packages are capable of filling many of the financial management needs of government–general ledger, accounts payable and receivable. For all currently known configurations, however, such packages will require substantial additional work to meet the complex central budgeting and accounting needs. There is a great body of evidence that each country will have its own idiosyncrasies that will produce a design that is unique to that country.

E. MANAGING IMPLEMENTATION

Implementation of budget and accounting system reforms is a long-term process. Such programs have been evolving in the OECD economies for several decades. A similar or longer-term timetable will be necessary in countries with less developed administrative processes.

For effective resource allocation, budget and financial management, systems must be developed around the core functions described in the preceding sections. Moreover, since the underlying requirements are similar, it may be feasible to draw on the growing number of off-the-shelf software packages to develop a core government budgeting and accounting system (CGBAS) that could (a) provide the basic transaction processing and database management functions needed for fiscal management in any country; and (b) allow the tailoring of controls, data entry and reporting functions to any country's needs. However, off-the-shelf software packages should not be regarded as the "off-the-shelf solution." As a minimum, they will require significant modification to accommodate the unique demands of a government system of resource allocation, budgeting and financial management. In fact, experience has shown that because of the unique set of institutional arrangements in each country, the design of the FMIS is unique to that country.

The case for developing a core system or identifying suitable software packages is strongest for the EITs. Development of the appropriate institutions to manage a market-oriented economy is of strategic importance to these economies. They are all starting from a similar administration base, so a core system should be readily applicable to all. Development of a CGBAS should greatly reduce the implementation time for all such systems.

The CGBAS should provide a sharper focus for much of the technical assistance provided by international bilateral agencies. The IMF, the World Bank, the regional development banks and the UNDP have provided assistance to improve various aspects of budgeting and accounting. The need for continuing efforts in this area is widely recognized. If a CGBAS were available, its features could be tailored to meet specific needs, and the implementation time would be much reduced from the broader approaches now being used. General support would continue to be needed. In each country, there would need to be a

comprehensive review of system requirements, administrative constraints and an appropriate phasing of implementation in light of these factors.

Centering the efforts on a CGBAS, however, should avoid the difficulties that arise from piecemeal development of systems. Clearly defined requirements would enable the systems to be designed to accommodate all budgeting and accounting objectives, whereas computerization of existing accounting systems would only meet the limited objectives of ensuring financial compliance. Information system development could then play a pivotal role in improving budgeting and accounting, providing that the policy and administrative environment is supportive.

Successful implementation of an integrated network of information systems is crucially dependent on cooperation among diverse users. Project preparation and implementation in a multi-agency environment is complex. Key requirements are securing sponsorship at the highest levels of government and participation by the widest range of users in all phases of the project. A necessary condition for sustainability of system reforms is for key decision makers to see information as critical to their work. A steering group with representatives from all major stakeholders should ensure that all of the needs of participating agencies are taken into account during system design.

Agencies will then not have to resort to independent and duplicative initiatives. Cooperationamong users would also establish systematic data-sharing arrangements, protocols and schedules between the various systems so that all agencies have access to financial data as needed. The organization in charge of a functional process for the component modules will be responsible for that process.

The number of technical staff and skills required to set up such systems are considerable. To ensure sustainability, an information system organization should be established, or existing organizational units strengthened, to incorporate and retain the skills and to manage planning, development and operation. The following skills are required: (a) high-level project design and planning skills; (b) project management skills; (c) technical implementation skills–to operate and use the hardware and software; and (d) user support skills–to develop user and technical documentation and to set up training and a hot line for end users.

Information system support would normally be distributed among several agencies across government. Therefore, coordinating mechanisms should be created to ensure that a common set of policies, procedures and standards are put in place for managing data and systems across government. The standards should cover: (a) the protocols for communications; (b) data entry; (c) editing and updating screen input and output formats; (d) back-up and recovery; and (e) security, contingency and disaster planning; and technical and user documentation.

Project planning methodologies should be used to design, implement and monitor the FMIS, and project management responsibilities should be clearly identified. Phased implementation would ensure that the system could be easily absorbed by organizations.

Hardware and software chosen must be supported locally. Vendors represented locally can provide training and technical support needed during the life of the system.

The links of integration

Several "links" are necessary to achieve true integration of the financial management system: training, coordination, harmonization, communication and collaboration. Most financial management systems fail due to the absence of these links.

A comprehensive training program covering all aspects of the IFMS is essential to ensure that all individuals involved in the subsystems understand the role, need and underlying concepts involved in each subsystem. All too frequently FM systems fail because budget personnel know nothing about cash management or debt management staff fail to consider accounting requirements. Training staff in each subsystem and other aspects of the system, e.g., internal controls and management principles, would contribute to the success of the system.

The coordination and harmonization of the IFMS component subsystems are necessary to achieve "integration." Harmonization is achieved by means of consistent provisions and standards governing application of each of the subsystems. The principles, policies, standards, manuals and procedures must be harmonized to avoid conflicts and inconsistencies between one subsystem and the others. Internal provisions for each subsystem must be coordinated with the other subsystems before being completed and issued in final form.

Collaboration among individuals is also important. Communication among staff inthe subsystems must be open. Periodic meetings, conferences or round table discussions should be held to discuss problems, areas of possible friction or duplication and common measures to be taken to achieve more operational efficiency.

Information systems normally have a direct effect on the way people do their day-to-day work. Appropriate change management procedures and training need to be carried out to ensure that staff feel comfortable in the new work environment and, in particular, do not feel insecure about their jobs.

Information systems may also lead to redefinition of the relative authority and power relationships of individuals and groups within organizations. Change management exercises need to cater to these complex effects also.

Partial integration

Full integration, like full computerization, may not be cost-beneficial in some countries. Varying degrees of partial integration are viable options. The most important element in any partially integrated approach is the integration of the budgeting and accounting systems so as to assure a commonly used data-base for managerial decision making and for budget formulation. System design should allow for the remaining systems to be integrated and expanded without redesign.

Each government can decide on a system after evaluating: the success of existing systems, the need to improve the systems and the opportunity to initiate integration as a part of improvement. The governments can then determine what degree of FMIS integration is reasonable to expect, what expertise will be required and what financing is available.

Data Architecture for Government Budgeting and Accounting System

Business Process	Data Entities Created	Definition
Line agencies prepare budget estimates	Line agency budget estimates	Description of programs and projects proposed by line agencies for the coming fiscal year and estimates of funds required by budget category
Receive budget authorizations from MOF after budget is finalized	Approved budget	Description of approved programs and projects to be executed by line agencies during the year and amount of funds voted
Prepare cash requirement forecast	Cash flow forecasts	Forecasts of cash requirements for the year based on known and anticipated commitments for both recurrent and capital expenditures
Assess liquidity position	Liquidity position	Status and forecasts of cash requirements and availability made at a specific point in the fiscal year, based on cash flow, forecast revenue projections, foreign aid inflows, and data on maturities of term deposits
Issue and redeem government securities	Issues and redemptions of government securities	Transactions relating to the issues and redemptions of government securities, short-term and cash deposits
Release funds to agencies	Budget warrants/ cash allocations	Periodic release of funds by MOF to sector agencies for specific budget categories within budgetary allocations
Request adjustments to budget authorizations (may involve transfer of allocations from one budget head to another, or supplementary authorizations to particular budget heads)	Requests for budget adjustments/ supplementary authorizations	Request by line agency for transfer of budget allocations from one head to another, or for supplementary funds for specific budget categories
Authorize budget adjustments	Budget transfers/ supplementary authorizations	Authorization made by competent authority (MOF/line agency official) for transfer of funds from one budget head to another, and supplementary authorizations to budget category
Prepare expenditure plans	Expenditure plans	Line agencies' projections of expenditure, based on planned programs and projects and available budget funds
Make request for goods and services	Procurement requests	Request for procurement of goods and services made out by managers within line agencies
Authorize expenditures	Expenditure/ procurement request authorizations	Authorized request for expenditure for goods and services or other forms of payment. Authorization carried out by line agency managers after determining validity of request and availability of budget allocations
Issue purchase orders	Purchase orders	Order for the purchase of goods and services issued by line agency or central supply organization specifying goods and services required and time of delivery
Commit funds		Transaction setting aside funds as a result of approval of specific requests for procurement of goods and services and issuance of corresponding purchase order
Receive bills for goods and services	Bills/invoices	Request for payment made by vendor to line agency for goods and services procured by that agency against a purchase order service

Business Process	Data Entities Created	Definition
Receive goods and services	Goods receiving report/certificate of completion of services	Certificate of receipt of goods/delivery of services required prior to release of payment
Authorize payment	Payment orders/ Payment vouchers	Authorization for payment against a bill or invoice made by line agency finance officials or treasury/MOF officials after determining availability of funds
Pay for goods and services	Check	Financial instrument authorizing recipient to draw money from line agency account with the treasury or authorized servicing bank
Administer payroll and employee benefits	Payments related to payroll	Payroll payments made to civil service employees
Administer pension and retiree benefits	Payments related to pension	Pension payments made to government pensioners
Service public debt	Debt service payments	Debt service payments made for government borrowings
Make other payments	Other payment types	Payments related to grants, subsidies, etc.
Receive requests for products/ services provided by line agency	Service requests	Request made by client for products/ services offered by line agency
Invoices for goods and services	Invoices	Request for payment made by line agency for products delivered or services rendered
Receive payments	Payment receipts	Financial transaction for receipt of funds (which may be for products/services delivered by agency)
Receive government tax revenues	Tax revenue receipts	Receipts of government tax revenues paid into the treasury
Receive government nontax revenues	Nontax revenue receipts	Receipts of government nontax revenues paid into the treasury
Receive loan proceeds, grants, etc.	Loan/grant receipts	Receipts of government loan proceeds/ grants paid into the treasury
Maintain budget and commitment ledgers	Budget ledgers	Record of transactions showing amount of budget authorizations and funds allocated for programs and projects and all changes to authorizations/funds allocations as a result of budget transfers or additional fund allocations via supplementary authorizations, with the authority and dates of various changes and totals of expense and commitment transactions against budget categories
Maintain accounts payable ledgers	Accounts payable ledgers	Record of payment and payable transactions carried out over the fiscal year
Maintain receipt/receivable ledgers	Accounts receivable ledgers	Record of receipts/receivable transactions carried out over the year
Maintain general ledgers	General ledgers/journal entries	Record of financial transactions classified according to chart of accounts
Develop cost of programs	Cost-accounting reports	Record of transactions recording costs incurred against programs and

Business Process	Data Entities Created	Definition
and projects		projects
Maintain store inventory ledgers	Stores/inventory ledgers	Record of transactions recording physical issues and receipts of goods in stores
Monitor and evaluate budget	Expenditure reviews	Periodic reviews of actual expenditures, analysis of variations with budgetary estimates, and comparison of financial and physical progress; consisting of overall budget reviews and agency reviews of programs and projects
	Fiscal reports	Periodic reports to monitor overall flow of appropriations and inflows of revenues over the course of the year, highlighting major deviations from planned budget program and suggesting corrective measures

Summary of Functional Requirements for the Budgeting and Accounting Modules of a Government Fiscal Management System [1]

Budget and Funds Control

The budget and funds control subsystems must include:

- expenditure control equivalent to funds allocation;
- financial and other data for budget and program estimates, and periodic budget reports;
- budget control at any nominated segment of the account code;
- budget control on a monthly or biweekly basis (or as required);
- control available either as a warning or to prevent a
- transaction taking place, as required;
- on-line checking of commitments and expenditure against
- availability of funds;
- adjustment to commitment at time of posting expenditure;
- on-line checking of forward commitment against limits; and
- formula-driven allocation function to enable a high-level
- allocation function to be split, in accordance with a user
- specified formula, to lower level allocations.

Purchasing

The purchasing subsystem must:

- provide access to a list of potential suppliers and vendor files and a means of maintaining these databases;
- allow recording of details of supplier performance;

[1] Extracted from the Report to the Information Exchange Steering Committee, Department of Finance, Government of Australia, December 1990.

- allow entry of requisitions (proposals for expenditure);
- allow entry and printing of purchase orders from any approved location by approved user;
- allow credit card transactions to be recorded, and provide facilities to reconcile transactions with monthly credit card statement;
- allow splitting of orders to multiple accounts;
- provide recording of receipt of goods/services, including partial delivery;
- accommodate variations to, and cancellation of, purchase orders; and
- accommodate multiple vendor addresses (e.g., different addresses for placement of order and payment).

Accounts Payable

The accounts payable subsystem must:

- provide facilities for registration and monitoring of claims;
- match purchase order, invoice, and delivery details;
- process credit notes from suppliers;
- generate recurring payments;
- provide a due date facility;
- allow payment of claims by credit card;
- allow recording of details of cash payments;
- accommodate many-to-many relationships between invoices and purchase orders;
- notify creditors on remittance advice if discount taken;
- provide facilities to enter check-butt/remittance advice details;
- allow splitting of payments to multiple accounts;
- record commitment if invoice does not relate to an existing purchase order;
- allow purchase order to be reopened by authorized staff after final payment has been made;
- verify transaction to avoid payment of duplicate invoices; and
- provide techniques to handle voided checks.

Accounts Receivable

The accounts receivable subsystem must provide facilities for:

- processing sales orders, invoices, and debit advice notes; and following up debt, including calculation of interest;
- producing age and trend analyses of debts;
- recording bad debts, write-offs and recoveries;
- recording details of agreements with debtors;
- registering credit notes from suppliers and issuing credit notes to clients;
- producing bank deposit slips;
- acquitting receipts against invoices; and
- maintaining debtor details.

General Ledger and Chart of Accounts

The general ledger and chart of accounts subsystem must provide:

- flexible coding system;
- automatic posting to subsidiary ledgers;

- transaction details for previous years;
- totals for previous years;
- cash commitment and accrual accounting;
- user-defined accounting periods;
- journal entry facilities;
- entry and reporting of nonfinancial information;
- account maintenance facilities;
- procedures associated with end of accounting periods;
- facilities for recurring accrual entries;
- facilities for a single transaction to have effect in two accounting periods;
- mechanism for cost allocation; and
- separate recording of expenditure and revenue (not just cash balance).

Internal Controls and Audit

The internal controls and audit system must allow the user/auditor to:

- ensure that all processing complies with statutory requirements;
- produce exception reports;
- reconcile subsystems with general ledger;
- obtain audit trails for all transactions associated with supplier and other master files;
- obtain transaction details to support account balances; and
- obtain audit trails to enable source documents to be traced to financial statements and vice versa.

Security

The security system must:

- provide facilities for electronic signatures, for internal user identification and authorization, and for external authorization and check production;
- log all transactions by user and terminal;
- record users' identification as part of the transaction record;
- limit access to data files and programs both through the system and through access methods external to the system;
- prevent alteration of financial data except through the posting of transactions that are entered through the normal edit and update process;
- provide a system-wide security facility covering all core modules;
- allow detection, reporting, and investigation of unauthorized access to data;
- prevent malicious or accidental destruction/misuse of data;
- provide a security management system that allows individual and generic user security profiles to be created, and that maintains and controls access to data and functions on the basis of these profiles;
- require a single user identification password to access all core modules to which access is allowed;
- allow a limit to be placed on the number of unsuccessful/unauthorized attempts at a particular operation; and
- provide an audit trail of unsuccessful/unauthorized attempts to access the system.

Backup and Recovery

The backup and recovery system must work in conjunction with the operating system, the transaction processing system, and the database management system to assist in:

- identifying data files that have been changed and those that will be saved for recovery purposes; and

- backing up all incomplete transactions, restoring the system to its last consistent state, and reapplying the transactions that have not been successfully posted since the last backup.
- This system should provide options for selective or full restores, incremental or complete backups, and on-line backups by excluding user access.

ANNEX 13:
THE UNITED STATES: FEDERAL HIGHWAY TRUST FUND

The United States established the Highway Trust Fund in 1956 to finance the federal share of the inter-state highway network and support most other Federal-aid highway projects. Later amendments extended funding to other transport programs as follows:

- The Highway Safety Act of 1966 made funds available for state and community road safety programs.
- In 1982, the scope was widened to permit the financing of mass transit.
- In 1991 the Intermodal Surface Transportation Efficiency Act confirmed the new role of the Highway Trust Fund as an "Intermodal Fund" by extending support to high speed rail and bike trails.

The funding system involved earmarking certain road-related taxes and depositing them into a special account, or road fund. The special account was primarily introduced to finance construction of the interstate highway network and was based on the user-pay concept. The concept involves two elements: first, the user pays, and second, the government credits the user fees directly to a highway special account. The user-pay concept is well established in the United States. All but six states and the District of Columbia now dedicate their user-fee revenues to special highway or transportation accounts.

The US Federal Highway Trust Fund exists only as an accounting mechanism. The taxes earmarked for the Trust Fund are deposited into the general fund of the US Treasury and a paper transfer of these taxes is made to the Trust Fund as needed. Earmarked tax revenues in excess of those required to meet current expenditures are invested in public debt and interest earned is credited to the Trust Fund. The Trust Fund finances the federal-aid highway program administered by the Federal Highway Administration. Since 1982 a portion of the Fund has also been used to finance mass transit projects administered by the Urban Mass Transportation Administration. Revenues from the highway portion of the Trust Fund are used to reimburse states for expenditures on *approved* projects. These include heavy maintenance (reconstruction, rehabilitation and resurfacing), road improvement, new construction, road safety programs, studies, and other highway related expenditures. The Trust Fund does not currently finance regular maintenance.

Trust Fund revenues are derived from a variety of highway user taxes, including: (i) motor fuel taxes on gasoline, diesel, and gasohol; (ii) a graduated tax on tires weighing 40 lbs. or more; (iii) a retail tax on selected new trucks and trailers; (iv) a heavy-vehicle use tax on all trucks with a gross vehicle weight (GVW) over 55,000 lbs; and (v) interest on the Trust Fund balance. Tax rates are adjusted as part of the regular budgetary process. In 1995, the tax rates were: gasoline = 12 cents/gallon; diesel = 18 cents/gallon; special fuels = 12 cents/gallon; tires = sliding incremental scale which varies from 15 cents/lb to 50 cents/lb over 90 lb; a 12 percent tax on the retail price of trucks over 33,000 lb GVW and trailers over 26,000 lb GVW; $100 plus $22 for each 1,000 lb over 55,000 lb GVW up to a flat fee of $550 for trucks over 75,000 lb GVW;

and interest at about 6.75 percent. In 1995 the revenues from the above tax rates were $17.323 billion (about 2/3rds from gasoline), $395 million, $2.0 billion, $682 million, and $548 million respectively, to give a total of $20.967 billion for the year. An additional $2.8 billion was likewise paid into the Mass Transit Account during the year.

Some vehicles like school buses and state, local government and non-profit vehicles are exempted from paying Federal Highway motor fuel taxes. In addition, fuels used in off-highway uses are exempt from these taxes (e.g., agriculture and industry. Coloring un-taxed diesel and testing non-exempt diesel vehicles to ensure they are using regular (taxed) fuel deal with off-highway uses.

The federal-aid highway program is a *reimbursable* program. What are allocated to the states are not cash, but a line of credit against which they can draw to meet obligations. Funds are allocated on the basis of formulas that, though not perfect, are difficult to change. The US Government Accounting Office has recently criticized the formulas, but concluded "Because the selection of a highway apportionment formula is a judgment for the Congress, GAO is making no specific recommendations." In other words, the allocation formulas are (at least in the US) highly political. The formulas are relatively simple and generally use variables like population, road mileage, and traffic density. For example, maintenance funds are allocated according to the following formula:

(interstate lane miles/total interstate miles)*0.55 + (vehicle miles on interstate roads/total interstate vehicle miles)*0.45

This means that the average allocation per state is about 2 percent of total maintenance allocations, subject to each state receiving a minimum allocation of 0.5 percent. Allocations do not cover all costs, but generally cover 80 percent of costs or, in the case of maintenance, 90 percent of costs (i.e., funds from the Highway Trust Fund are provided on a cost-share basis). In looking at this allocation formula, the GAO suggested consideration of two alternatives:

Alternative 1 Distribution based equally on (i) total lane miles and (ii) total vehicle miles traveled.

Alternative 2 Distribution based equally on: (i) total lane miles, (ii) interstate vehicle miles traveled and (iii) state population.

Payment for work financed through the Highway Trust Fund is made in the following way:

(i) A contractor does work

(ii) Contractor is paid by the state.

(iii) Vouchers for reimbursement (usually covering several project withdrawals) are sent to FHWA for review and approval.

(iv) Claims are certified by FHWA (this is a formality and certification is automatic).

(v) Certified schedules are submitted to Treasury.

(vi) Electronic funds transfer Federal share to State bank accounts.

Each state participating in the scheme is required by law to have an annual audit carried out. The audits are normally carried out by outside auditors and cover financial and compliance and internal control procedures (i.e., it is more extensive that a purely financial audit, in that it also covers control procedures, etc.). Staff from FHWA also check these procedures on an ad hoc basis. There is no formal technical audit. Staff from FHWA used to carry out field inspections but this has ceased due to staff shortages. However, occasional field inspections are still carried out.

FHWA is also subjected to an annual audit to ensure it follows laid down procedures and can account for funds spent. About 3,000 staff manages the federal-aid highway program. They are stationed in Washington and in each of the states.

Annex 14: Evaluation Capacity Development in the Australian Government

Executive Summary

The Australian federal government has given a high priority to ensuring that evaluations of its programs are conducted and the findings used. The approach, which has been adopted to develop evaluation capacity, has entailed a combination of formal requirements for evaluation plus their strong advocacy by a powerful, central department (the Department of Finance (DoF)). This has enabled evaluation to be linked both to budget decision-making and to the management of government programs.

As a result, there is clear evidence of a high level of evaluative activity and that evaluations are actually used to assist Cabinet's decision-making and prioritization in the budget and to support internal program management within line departments.

More recently, the Australian system has evolved from one of tight, formal controls and requirements to more of a voluntary, principles-based approach. In this new environment, it is hoped that the strong pressures for line departments to achieve and to demonstrate high levels of performance will be increased and that the existing evaluative culture and infrastructure will be strengthened. In particular, the latest wave of public sector reforms promise a closer integration of performance measurement–including evaluation–into performance management and governance more broadly.

There are many lessons here for the development of evaluation capacity in developing countries. A number of these lessons are identified and discussed in this Annex.

Genesis and Stages of Development

An understanding of the development of evaluation capacity in the Australian government is important because of the insights it provides for other countries. Evaluation capacity development (ECD) did not develop in a linear, logical sequence in Australia; rather, it grew in an opportunistic manner in response to prevailing imperatives. The twists and turns of these developments mean that a large body of experience has been amassed concerning what works, what does not, and why. The objective of this annex is to share these insights.

As with other developed countries, evaluation is not a new phenomenon in Australia. Cost-benefit analysis–the appraisal of investment projects has–been part of the scene for many decades. It has been conducted by the various government economic research bureaus that have existed, and by other advisory bodies and line departments concerned with infrastructure and agriculture investments.

Formal program evaluation has a more recent origin. It too has been conducted by specialist research bureaus attached to line departments, and also by special policy review

taskforces, focusing on areas such as labor market programs and social welfare policy. But as a discrete and on-going focus of government activity its heyday started in the 1980s.

The election of a reformist Labor government in 1983 provided an environment that was strongly encouraging of evaluation. The new government was determined to improve the performance of the public sector while at the same time achieving tight public expenditure restraint through the annual budgetary process.

A series of public sector management reforms was implemented in the first several years of the new government. One aspect of these reforms was the desire to 'let the managers manage' by devolution of powers and responsibilities–reflecting the philosophy that public sector managers would be strongly encouraged to improve their performance if they were provided greater autonomy and the potential to manage their departments with fewer central agency controls and less interference. Another aspect of the reforms was 'making the managers manage', and this thread was more directly linked to the powerful budgetary pressures which existed.

The more tangible changes included:

- substantial autonomy for departments in their spending of administrative expenses (including salaries), but with these administrative expenses being strictly cash-limited;
- greater surety about future resource availability to departmental managers via a system of three-year forward estimates of administrative and other program expenses; and
- a major reduction in the number of departments through amalgamation, in order to achieve less balkanized policy advice and to encourage the internal reallocation of resources through portfolio budgeting.

A related set of principles was embodied in the Financial Management Improvement Program, which included program management and budgeting. These principles emphasized the importance for departmental managers in ensuring that their program objectives were realistic and to help guide managers and staff alike. The principles also encompassed a focus on the efficiency and effectiveness of programs–i.e. on program performance–through sound management practices, the collection of performance information and the regular undertaking of program evaluation. Guidance material extolling the virtues of these principles and clarifying concepts was issued by the DoF together with the then Public Service Board, another central agency.

These initiatives were introduced in a stringent budgetary climate. Macroeconomic concerns provided sufficient motivation to induce the government to reduce the share of federal government outlays in GDP from 30 percent in 1984-85 to just over 23 percent in 1989-90. The impact of these cuts on government programs was even greater than these raw statistics would suggest, because the government was also determined to increase the real level of welfare payments to the most disadvantaged in society. It achieved this by means of tight targeting of benefits, and this entailed substantial reductions in 'middle-class welfare'.

This package of financial management and budgetary reforms was substantive and wide-ranging. For several years, it placed the framework of public sector management in Australia at the forefront of developed nations.

DoF was a major architect of many of these reforms, reflecting its role as budget coordinator and overseer of the spending of other departments. DoF was keen to get out of the detail of spending issues, where it was often bogged down in minor spending bids and disputes with departments. Its concern with budget spending encompassed not simply a priority on cutting government outlays, but also in finding ways to make spending more efficient and effective.

This concern with value for money helped to lay the groundwork for DoF's provision of advice to departments on the evaluation of their programs. It commenced this role in a formal sense with the publication of an evaluation handbook in 1986.

At around the same time there was growing disquiet in DoF and other central agencies about the lack of real progress made by line departments in managing their performance. In early 1987, the Minister for Finance took the lead role in securing Cabinet's agreement to a formal requirement that all new policy proposals for Cabinet consideration should include a statement of performance measures as well as proposed arrangements for future evaluation. Line Ministers and their departments were also required to develop plans for the systematic and comprehensive monitoring and evaluation of the performance of their programs, and for the reporting of these reviews to government. DoF was also to be kept informed of departments' evaluation plans.

DoF augmented its earlier advisory role through the provision of additional guidance material in 1987, and via some limited provision of a basic evaluation training course. By early 1988, however, the evaluation plans prepared by departments could best be described as patchy, and many were poor, and it had become apparent that a more fundamental examination of evaluation practices in departments was warranted. Thus DoF undertook a diagnostic study reviewing departments' evaluation progress and the overall health of evaluation activities in the public service. The study found:

- a lack of integration of evaluation into corporate and financial decision-making;
- that evaluations tended to focus on efficiency and process issues rather than on the more fundamental question of overall program effectiveness;
- a poor level of evaluation skills and analytical capacity; and
- that the role of central departments, especially DoF, was unclear.

This diagnostic study laid the groundwork for a major submission from the Minister for Finance to Cabinet in late 1988 seeking–and securing–its agreement to a formal, ongoing evaluation strategy for all departments. A key, and continuing, principle underlying this strategy was that 'the primary responsibility for determining evaluation priorities, preparation of evaluation plans and conduct of evaluations rests' (with departments).

The evaluation strategy had three main objectives. It encouraged program managers within departments to use evaluation for the improvement of their programs' performance. It also provided fundamental information about program performance to aid Cabinet's decision-making and prioritization, particularly in the annual budget process when a large number of competing proposals are advocated by individual Ministers. Lastly, the strategy aimed to strengthen accountability in a devolved environment by providing formal evidence of program managers' oversight and management of program resources. The emphasis was on transparency,

which is of interest to the parliament, particularly in the senate's processes of budget scrutiny and approval.

The evaluation strategy has provided the framework and driving force underlying the progress with (ECD) in the Australian government since that time. Its key components comprised four formal requirements. These were:

- that every program be evaluated every 3-5 years;
- that each portfolio (i.e. comprising a line department plus outrider agencies) prepare an annual portfolio evaluation plan (PEP), with a 3-year forward coverage, and submit it to DoF. PEPs comprise major program evaluations with substantial resource or policy implications;
- that Ministers' new policy proposals include a statement of proposed arrangements for future evaluation; and
- that completed evaluation reports should normally be published, unless there exist important policy sensitivity, national security or commercial-in-confidence considerations, and that the budget documentation which departments table in parliament each year should also report major evaluation findings.

A crucial aspect of this evaluation strategy was the role that Cabinet agreed to assign to DoF. Cabinet expressed its expectation that DoF would have the opportunity to make an input to PEPs and to the terms of reference of individual evaluations to ensure that they were consistent with government-wide policies and priorities, and that DoF would be available to participate directly in selected evaluations, subject to negotiation between DoF and the line department (or between their Ministers if a dispute arose). DoF was also assigned a role in providing detailed advice and handbooks on evaluation methodology, and on management information systems, and in taking the lead in identifying and sharing best practices.

A key to the public sector reforms that DoF had advocated was the need for central departments to get out of the detail and out of a control mentality. While the leadership of DoF were true believers in the utility of evaluation, it could be argued that they had advocated a more hands-on involvement for DoF with some considerable hesitation, because it represented an activist and closely monitoring approach. DoF's advocacy of the powerful role that it was assigned by Cabinet only came after there was clear and strong evidence of the failure of line departments to live up to the rhetoric of program management and budgeting which they also had espoused.

While the evaluation strategy was still at the proposal stage, most line departments stated their acceptance of the utility of evaluation but expressed real concern about 'intrusive DoF involvement.' This stated acceptance of the principles was at odds with the actual reality of management in most line departments, and was a feature of other performance measurement and performance management initiatives introduced in later years.

That Cabinet agreed to DoF's role in the face of sustained opposition from line departments almost certainly reflected the influence of the Minister for Finance, and of his department, in a period of very tight expenditure restraint. Evaluation offered the promise of a tool to help better inform Cabinet's decision-making and prioritization among different spending and savings options.

The next milestones for ECD in Australia were two reports, from a parliamentary committee in 1990 and from the national audit office in 1991. These reports acknowledged the substantial effort being devoted to the planning and conduct of evaluation, but argued for renewed efforts to be made. In particular, they noted with some concern the variation in the extent of evaluation activity in different departments, and argued for a more active role by DoF to encourage evaluation.

These reports were soon followed by the creation in 1991 of a separate branch within DoF, responsible for the provision of evaluation advice, support, training and encouragement to other departments and also within DoF itself. This branch had 9 evaluators able to provide assistance and it acted as a focal point and catalyst for evaluation throughout the Australian public service. The branch was also co-located with two other branches responsible for overall coordination and management of the government's annual budget process and for public sector management reforms more generally.

As discussed in the following section of this annex, evaluation in the Australian government–as measured by the extent of evaluation planning, conduct and use–had achieved a healthy and vigorous state by the mid-1990s.

However, by that time DoF was concerned about departments' poor progress in articulating clear and achievable objectives for their programs and in collecting and reporting meaningful performance information on a frequent basis. These concerns were confirmed by two reviews of departments' annual reports and of their budget documentation, which DoF commissioned. This evidence was somewhat ironic, because evaluation is at the difficult end of the performance measurement spectrum, and it was generally being done well, yet program objectives and performance information are at the easier end of the spectrum, and they were being done poorly.

Thus in 1995 DoF secured Cabinet's agreement to a rolling series of comprehensive reviews, staggered over 3 years, of the program objectives and performance information of all departments. These reviews are being conducted jointly by DoF and each line department, with the results being reported to their respective Ministers and to Cabinet as a whole. The reviews focus in part on the existing state of play, but more importance is attached to identifying ways in which objectives and performance information could be improved in the future, and in mapping out and committing to a plan of action to achieve these improvements.

This perhaps illustrates, once again, that public sector management initiatives often require a push from the center to make them happen in many departments.

The election of a Liberal/National Party government in 1996 has led to an emphasis on cutting bureaucracy, red tape and the large number of formal reporting requirements. The new government has required that existing programs be comprehensively reviewed by Ministers and their departments to establish whether or not they should continue, or whether they should be abolished or devolved to another level of government. For those programs which are to continue to be delivered at the federal level, there is an expectation by Cabinet that a competitive tendering and contracting process be undertaken wherever possible.

One concern that has emerged with the formal evaluation requirements in recent years is that their concern with bureaucratic process is no longer appropriate–thus the length of some portfolio evaluation plans, for example, has grown from a recommended 20 or 30 pages in length to over 120 pages. A consensus has emerged within the bureaucracy that while it is important to have evaluation findings available to assist decision-making by program managers and by Cabinet, detailed and elegantly-worded plans are not necessary to achieve that end.

There is also a related and powerful strand of thinking that departments should not be encumbered by excessive controls on their internal activities, as long as departmental heads and senior executives are responsible for performance, and that responsibility is reflected in their employment contracts. This is essentially a 'let the managers manage' philosophy, and is analogous to the one adopted in the early 1980s. A difference, however, is the greater scrutiny by Ministers of the performance of their department heads–as exemplified in the more widespread use of employment contracts–plus the apparent readiness of Ministers to remove department heads from their positions where their performance is judged to be wanting. And perhaps the most important difference of all is the progress in the intervening years in establishing an evaluation culture, and in establishing departmental infrastructures to support performance measurement and management.

This evolution in philosophy led, in late 1997, to a further development in the evaluation strategy into a principles-based, performance measurement framework (i.e. evaluation plus performance information). Such an approach has been accepted by Cabinet, and is now government policy. Such a Cabinet-endorsed, principles-based approach provides guidance to the heads of line departments by emphasizing the good practice features of performance management and measurement. It implicitly reflects the strong expectation that CEOs and senior executives will continue to plan, conduct and use evaluation, and so it implicitly takes the progress achieved to date as a given. These issues go to the heart of the question whether central controls should be tight or loose.

Evidence of Progress with ECD

It is important to have a realistic understanding of the extent of ECD in Australia. All too often, national reviews of progress with evaluation in developed countries present too rosy a picture, particularly when external reviewers confuse rhetoric with reality. Checklists of evaluation activities undertaken do not necessarily translate into the widespread conduct of evaluation, nor into quality and rigor in evaluation, nor into its actual use in program management and government decision-making.

The extent of ECD in Australia can be assessed by considering the planning, conduct, quality and use of evaluation.

Evaluation Planning

All government departments prepare portfolio evaluation plans, and have done so since 1987-1988. These are intended to comprise the major evaluations in each department and its outrider agencies–in recent years about 160 of these evaluations have been underway at any given time. The majority of these evaluations are major, in that the programs have significant

policy or spending implications, although a significant minority of these evaluations, particularly for the smaller departments, is only of minor programs or of efficiency aspects of large programs. (The plan guidelines issued by DoF recommend that the main focus of these evaluations be on issues of program effectiveness. Departments are separately encouraged to plan and to undertake more minor evaluations for their own internal management purposes.)

Line departments themselves decide which programs should be included in the plans for evaluation, and also which issues the evaluation terms of reference would cover. However, DoF would usually endeavor to influence departments' choice of evaluation priorities by making direct suggestions to them. In making these suggestions, DoF would attempt both to anticipate and to create the information needs of Cabinet. Where DoF has had difficulty in persuading departments, it has sometimes approached Cabinet directly to seek its endorsement of particular evaluation suggestions and also detailed terms of reference; Cabinet almost invariably accepts DoF's suggestions.

The Cabinet-endorsed, formal requirement under the evaluation strategy that portfolio evaluation plans be prepared and submitted to DoF certainly provided a powerful incentive to line departments to prepare plans and to take them seriously. Another influential factor was DoF's issuance of formal guidelines to departments on the desirable content of these plans, together with follow-up monitoring and reminders to departments about the need for the plans. The evaluation branch of DoF conducted internal reviews of the content and coverage of these evaluation plans and provided feedback and prompting to departments as well as identifying good practice examples. More formal feedback and analysis has also been provided by the national audit office on several occasions, via several efficiency audits into program evaluation which it has conducted.

The formal requirement that all programs be evaluated every 3-5 years was also influential in creating a climate of expectation that evaluation is the norm rather than the exception. The concept of regular, comprehensive coverage of programs also encouraged a planned, staged approach to evaluation. This formal requirement should not be accepted at face value, however. It is very seldom the case that all aspects of a program[1] are included in any single evaluation. Instead, it is usual that an evaluation will focus only on certain key problems or aspects of a program. The challenge is to ensure that these difficult issues are actually evaluated, and this is a role in which DoF has played an active role via persuasion and via direct involvement in individual evaluations.[2]

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[1] The three dimensions on which program evaluation can focus are (i) the efficiency of a program's operations, (ii) its effectiveness in achieving its objectives, and (iii) whether the program's objectives remain consistent with the government's policy priorities, i.e. the appropriateness of the program.

[2] There was only modest success with the requirement that Ministers' new policy proposals include an evaluation plan of action that would be undertaken if the proposal was accepted. Feedback from portfolios indicated that this requirement was onerous for portfolio managers during the busy budget period. Only about 30 percent of proposals broadly met this requirement in the 1993-1994 budget, for example, although an additional 50 percent of proposals included a clear undertaking to evaluate the proposal if accepted (DoF 1994). These percentages were only achieved after considerable prodding by line areas within DoF. In recent years the extent of such prodding and of departments' willingness to provide such plans in their budget documentation has fallen off considerably.

Conduct of Evaluation

The large number of evaluations in progress, and the fact that over 530 evaluation reports have been published over the last four years or so, attest to the existence of extensive evaluation activity in the Australian government. This has provided a growing 'library' of evaluation findings.

DoF maintains a register of published evaluation reports, and this helps to monitor the progress of individual departments' activities. More importantly, it helps to share evaluation practices and methods among departments and this also provides some quality assurance because the public availability of these reports exposes them to peer scrutiny.[3]

Evaluation Quality

Quality of evaluation reports is a more difficult dimension to measure. The rigor of program evaluations depends on the expertise and objectivity of the evaluators. The national audit office commissioned a recent assessment of the quality of a small sample of evaluation reports. It found that over a third of a sample of evaluation reports suffered from methodological weaknesses of one kind or another. It is certainly the case that some published evaluations are of low quality, and the suspicion is that some of these are produced for self-serving purposes, such as to provide a justification for the retention or expansion of the program.

DoF's own experience of evaluations is that their quality can vary enormously. The extent to which this should be a matter of concern is another matter, and an issue to consider here is the intended uses of evaluations. If the intended audience of an evaluation is Cabinet (to aid its decision-making) or the parliament (for accountability purposes) then a poor quality or misleading evaluation provides particular cause for concern. DoF has certainly been willing to provide Cabinet with a dissenting view on the quality of an evaluation in those cases where an evaluation is used by a line department to attempt to influence a Cabinet debate. (Line departments would typically try hard to avoid such disagreements, which would be virtually guaranteed to attract the ire and condemnation of Cabinet.)

Where line departments choose or allow poor-quality evaluations to be conducted and these evaluations are intended for internal program management purposes, however, then there is perhaps an element of caveat emptor. Thus the extent of evaluation quality assurance or quality control could be regarded as an issue for departments' internal management to address.

A commonly asked question is how evaluation quality can be ensured and what the role of DoF is or should be in guaranteeing quality. In past years, parliamentary committees and the national audit office have argued that DoF should take a strong role. DoF has not assumed a formal role here, however. It has preferred to seek to participate directly in certain major evaluations, usually via steering committee membership, thus ensuring that evaluations address the difficult questions and do so in a rigorous manner. But it would be a very resource-intensive activity to undertake detailed reviews of all evaluations, and it would also be inconsistent with the devolutionary reform philosophy for it to assume such a role.

[3] A survey of all departments conducted by the national audit office found that 75 percent of evaluations conducted in 1995 and 1996 were released to the public and/or available on request (Australian National Audit Office (ANAO) 1997).

The national audit office has consistently argued that departments should set up central oversight procedures to achieve quality assurance of evaluations conducted by line areas within the department. There is certainly evidence from those few departments that have followed this approach, that it is an effective means of bringing to bear needed evaluation skills and expertise, and of ensuring evaluation quality.

Use of Evaluation

A bottom-line issue is the extent to which evaluation results are actually used. If their use is patchy or poor then there really is little point in conducting evaluations. The large volume of evaluation activity in itself provides some reassurance that evaluation findings are being used–in an era of very tightly limited administrative expenses, departments would simply not bother to conduct evaluations unless they were going to be used. (And DoF also would not bother to advocate and work to influence the evaluation agenda unless it perceived real potential value in their findings.)

There is clear evidence that evaluations have been used intensively in past years in the budget process. DoF has conducted several surveys of the extent of the influence of evaluation findings on the budget proposals submitted to Cabinet for its consideration. These have been surveys of DoF officers to seek their judgment concerning the extent of the influence of evaluation. While the survey results should be regarded as providing no more than a broad indication of the extent of influence, they are nonetheless very revealing.

In the 1990-1991 budget, some A$230 million of new policy proposals submitted by line Ministers were judged to have been directly or indirectly influenced by the findings of an evaluation. By 1994-1995 - the latest year for which estimates are available–this had risen to A$2300 million. (Measured in dollar terms, the proportion of new policy proposals influenced by evaluation rose from 23 percent to 77 percent over that period.) In most cases the influence of evaluation was judged by DoF to be direct.

A 1994 review of evaluation activities in one of the largest departments, the Department of Employment, Education and Training (DEET) found that considerable use was being made of evaluation findings in that department.[4] The review, conducted jointly by DEET and DoF, surveyed a large sample of completed evaluations and found that

- 55 percent had led to changes in program management;
- 8 percent had resulted in an improvement in the quality of program outputs;
- 10 percent had influenced new policy proposals sent by the line Minister to Cabinet for its consideration; but
- that there was considerable unevenness within DEET in the quality and use made of evaluation findings - some line areas of DEET had maintained a high standard, while other areas were either consistently poor or were uneven

Source: DEET/DoF (1994)

[4] The recent national audit office survey found that, for evaluations conducted over the period 1995 - 1997: about half examined the delivery of products or services to external clients; a further 30 percent were associated with matters internal to the department; one third of the evaluations examined the appropriateness of new or established programs; and 15 percent were directed at the development of policy advice for the government (ANAO 1997).

There were some unique features of the 1994-1995 budget that resulted in these figures being particularly high. Nevertheless, the results indicate the importance which public servants–in their preparation of the details of new policy proposals–and Ministers have attached to having evaluation findings available. Overall, it has been very important to have the active support of key Cabinet and other Ministers in encouraging portfolios to plan and conduct high-quality evaluation.

It is also the case that evaluation can have a significant influence on the savings options put forward by DoF or by portfolios for Cabinet consideration in the budget process. In 1994-1995 about A$500 million of savings options–or 65 percent of the total– were influenced by evaluation findings.

One issue that is important to appreciate is the realistic limits to the influence of evaluation on Ministers' or Cabinet's decision-making. The evaluation paradigm in an investment project is typically that of cost-benefit analysis: a project is warranted if, but only if, its benefit-cost ratio is greater that one. But program evaluation is a more qualitative science: it can help identify the efficiency or effectiveness of existing, ongoing programs but it can rarely provide an overall conclusion that the activity is worthwhile or not.

To give an example, if government decides to allocate a large amount of spending to the unemployed, program evaluation findings can help to map out the likely consequences of alternative types of labor market intervention such as wage subsidies, public sector job creation, labor market regulation, etc. In other words, program evaluation can be used to attempt to identify the cost-effectiveness of each type of intervention. But program evaluation can usually not identify the overall amount of resources that should be allocated. That is a political decision, which is why governments are elected in the first place. Thus the most that program evaluators can realistically and legitimately hope for is that their findings are an influential input into government's decision-making and prioritization among competing proposals and programs (see box on previous page).[5]

Success Factors - What Has/Has Not Worked, And Why

The preceding discussion of the development of ECD and of progress achieved to date has identified a number of success factors. These are considered below, together with other success factors and some thoughts on their relative importance.

The Department of Finance

DoF has played a leading and central role in ECD in the Australian government, and there have been advantages and some disadvantages in this. Overall, however, DoF's considerable clout with departments and with Cabinet has given it a powerful and influential role in promoting evaluation. This has been perhaps the single most important factor in the substantial degree of progress with ECD in Australia.

[5] In the absence of evaluation findings, decisions will likely be influenced more by ex ante analysis and/or anecdotal information and case study examples.

DoF has an influential, devil's advocate role in advising Cabinet about the level of funding which should be allocated to departments for different government programs. As part of this function, it provides advice on the new policies proposed by line Ministers and on possible 'savings options', i.e. areas of government expenditure which could be trimmed or abolished entirely.

This role does not endear it to other departments, and in fact is an impediment to close cooperation and trust between other departments and DoF. On the other hand, DoF also plays a day-to-day role with departments in advising on funding and policy issues, participating in reviews and evaluations of their programs, and providing advice on evaluation and other public sector management tools. In the evaluation area, DoF's evaluation branch, with its nine evaluators, provided desk officer assistance to departments with advice on methodology, best practice, provision of training courses, publication of numerous evaluation handbooks and guidance material, and support for evaluation networks of practitioners.

The nature of these relationships can vary considerably, with other departments viewing DoF at best as a useful source of advice and treating it with wary respect, and at worst with downright hostility. The former relationship is much more common than the latter, however.

As the evaluation 'champion', DoF has succeeded in getting evaluation 'on the agenda' in its work with departments. This perhaps stands in contrast to the situation which faced the former Office of the Comptroller-General (OCG) in Canada in the early 1990s. OCG was a stand-alone, specialist body also responsible for attempting to influence line ministries to adopt evaluation as a management tool. The difficulty faced by OCG was the perception that it was tangential to mainstream government activities, and this undercut its influence. It is interesting to note that OCG's functions have now been relocated as part of the Treasury Board Secretariat, the Canadian equivalent of DoF, in order to increase its clout in dealing with line ministries. This relocation was undertaken after a review in 1993 by the Canadian Auditor General of overseas practices, including in particular Australia's.[6]

Another advantage of having DoF responsible for evaluation oversight is that it ensures a direct influence on the line areas of DoF, which oversee the line departments. Before the devolutionary reforms of the past fifteen years, DoF was heavily involved–some would even use the phrase 'bogged down'–in the detailed scrutiny of departments' spending activities. The more recent focus on evaluation and other public sector reforms has helped foster a greater focus in these line areas on bottom-line outcomes and value for money; DoF is simply too important a bureaucratic player to allow it to remain with outmoded attitudes and activities. However, achieving this needed cultural change in DoF has been a slow process over a number of years and has involved substantial staff turnover.

The greater focus on value for money has also flowed through to the nature and quality of policy advice that DoF provides to Cabinet. That advice has increasingly drawn on available evaluation findings, thus also helping to raise the profile of evaluation with line departments. DoF's involvement in selected evaluations also provides some quality assurance to Cabinet about the evaluation findings on which proposals for new policy might be based.

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[6] Auditor General of Canada 1996.

An Example of the Use of Evaluation to Help Government Cut and Reprioritize its Programs

In the 1996-1997 Budget, the new government was determined both to reduce and to reprioritize government spending. Particular focus was given to labor market and related programs, which accounted for spending of A$3,800 million annually.

The Minister for employment articulated the government's overall policy goal as providing assistance to the long-term unemployed and to those at risk of entering long-term unemployment. This focus was adopted both for equity and efficiency objectives–the latter pursued by achieving a better matching of labor supply and demand. At the same time, the minister wanted to achieve better value for money from labor market programs in the tight budgetary environment.

Australian and international evaluation findings were drawn on heavily to help guide the policy choices made. The Minister highlighted the relative cost-effectiveness of different labor market programs. A key measure of this was estimated by calculating the net cost to government for each *additional* job placement from different programs–as measured by the *increased* probability of an assisted person being in a job some 6 months after they had participated in a labor market program. (The baseline was a matched comparison group of individuals who did not participate in a program.)

Evaluation findings showed that the JobStart program, which provides wage subsidies, had a net cost of A$4,900 per additional job placement, whereas the JobSkills program, which was a direct job creation program, had a net cost of A$76,600. The Minister noted that "the Government will be concentrating its efforts on those programmes which have proven most cost-effective in securing real job outcomes". As a result, the JobStart program was retained while the JobSkills program was substantially scaled back and more tightly targeted to jobseekers that were particularly disadvantaged.

Total savings to the government from its reduction and reprioritization of labor market programs were about A$1,500 million over two years.

Cabinet also commissioned a series of major evaluations into its new labor market programs and into the new arrangements for full competition between public and private employment service providers.

Source: Senator Vanstone (1996); DEETYA (1996); Commonwealth of Australia (1996).

An interesting example of the evaluative culture which has grown in DoF, and arguably in the then Cabinet itself, was Cabinet's agreement to commission some 60 major reviews of government programs. These reviews had been suggested by DoF in the 1993-1994 to 1995-1996 budgets, with most focusing on issues of effectiveness and appropriateness; many of these reviews surveyed and summarized existing evaluative information, rather than conducted in-depth evaluations themselves.

The reviews related to aspects of programs that collectively involved about A$60 billion in annual expenditures. These reviews were designed as an urgent response to emerging budget pressures, and might best be viewed as complementary to the regular cycles of evaluation as reflected in portfolio evaluation plans. Such Cabinet-endorsed reviews can also be a useful vehicle for DoF to use if line departments strongly resist DoF suggestions about evaluation priorities.

A benefit to line departments from DoF involvement in individual evaluations is that it can draw on a range of evaluation skills and experience, spanning the whole breadth of government activities. Most DoF officers are usually not specialists in technical evaluation issues –they are expenditure and financial policy specialists. Perhaps their greatest potential value-added is the objective approach which they can bring to bear to an evaluation–DoF officers are comfortable in asking the difficult questions about a program's performance and in steering an evaluation towards these issues. This independent and questioning approach has provided a useful counterpoint/balance to the in-depth knowledge but often–partisan approach of program areas within line departments.

Line Departments

Most of the day-to-day work of line departments relates to ongoing program management. As discussed earlier, one of the three objectives of the evaluation strategy is to encourage program managers to use evaluation for the improvement of their programs' performance. This has proved surprisingly difficult at times.

To those who understand the potential contribution of evaluation, its utility seems almost self-evident. Thus evaluators often plea along the lines 'how can you program managers improve your programs and better meet the needs of your clients unless you carefully evaluate program performance?' Unfortunately, motherhood appeals to the professionalism of senior executives are not terribly effective. Most managers understand the potential benefits of evaluation, but often do not view it as being at the top of their day-to-day priorities, particularly in a climate of tightly constrained and diminishing resources.[7]

Experience within line departments in Australia indicates that a highly supportive culture is necessary if major evaluations are to be planned, resources allocated to properly manage and undertake them, and the findings implemented. The commitment of departmental secretaries (the CEO) to achieving improvement in program performance is paramount in fostering such a culture.

Over at least the past decade, the tenure of secretaries has often been brief, lasting only a few years. This turnover has meant that some departments have had a series of secretaries who have varied considerably in the priority that they have attached to evaluation and to the departmental effort that should be devoted to it. While an evaluative culture can be slow to build up, it can and has been reduced much more rapidly on occasion.

The earlier discussion on the reprioritization of labor market programs provides one, high-profile example of the potential benefits of evaluation to Ministers and their departments. More generally, there has been an emphasis in recent years on 'portfolio budgeting'. This includes the setting by Cabinet of portfolio spending targets at the start of each annual budget round. In the tight budgetary environments that have predominated, the nature of these targets usually imply that if Ministers wish to propose any new policies then they must be funded from within the portfolio's existing spending envelope. Evaluation has been one tool to assist Ministers

[7] A 1992 evaluation of public sector management reform in Australia concluded that "there is widespread acceptance of the importance of evaluation". But it went on to note that "the bulk of (senior executive managers) state that it is using evaluation information only sometimes or infrequently during the conduct of their job. This suggests that information generated by evaluations is not yet a key element in program management". (Task Force on Management Improvement 1992, pp. 378 and 379.)

and their secretaries not only in the design of new policies but in the prioritization among existing policies (subject, of course, to Cabinet's endorsement).

An advantage of the requirement for portfolio evaluation plans is that it has necessitated that departments set up a bureaucratic infrastructure to prepare them (which may be a flaw when the government is determined to cut red tape and the bureaucracy, as at present). In about three-quarters of departments this has involved the creation of a committee, usually chaired by a deputy secretary of the department, to meet regularly, to canvass candidate programs for future evaluation, and to monitor the progress of evaluations already underway.[8] This work itself generates bureaucratic momentum. Most if not all departments also involve their Minister and their Minister's office by seeking their comments on and clearance of the draft evaluation plans.

A large majority of departments have chosen to set up evaluation units to coordinate their formal evaluation planning. At their smallest, these units comprise two or three individuals. In some departments, such as employment, there is a separate branch of 20-25 staff responsible for evaluation planning, provision of advice on evaluation methodology, participation in steering committees, and the conduct of a number of major evaluations, particularly in the area of labor market programs (but typically not of education programs, which also comprise a substantial proportion of the department).

It is difficult to speculate with any confidence how the evaluation 'scene' in Australia would have looked in the absence of a powerful champion such as DoF. Some of the larger departments, such as the departments of employment and health, would no doubt have had a substantive evaluation effort in any event. However, informal discussions with senior executives in those departments have emphasized the important catalytic role played by DoF even in their departments. Executives responsible for the central evaluation areas in line departments have generally found DoF to be a natural ally in helping to persuade the more traditional administrators in their departments to adopt evaluation as a valued management tool.

Most departments have chosen to rely on program managers and their staff for the actual conduct of evaluations. This devolutionary approach has helped to 'mainstream' evaluation as a core activity of each line area, and has ensured that evaluations draw heavily on the program knowledge and experience of those who actually manage the program. It has also led to a greater appreciation of the complementarity–and sometimes the substitutability–between in-depth program evaluation and the more frequent collection of ongoing performance information.

The devolutionary approach has also been important in securing the 'ownership' by program managers of the evaluation findings. These are important advantages, and provide a strong contrast with externally-conducted evaluations, reviews or performance audits where lack of program knowledge and commitment to implement the findings has often significantly undermined their impact.

But there have also been disadvantages to this devolved approach. One has been a lack of evaluation skills in many program areas and inexperience in conducting evaluations, as suggested by the recent survey by the national audit office of a sample of evaluation reports.

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[8] See ANAO 1997.

Basic training in evaluation skills is widely available in the Australian government–provided by DoF in particular[9]–as is DoF and departments' own guidance material such as evaluation handbooks. There is also a fairly large community of evaluation consultants in Canberra. However, the recent national audit office study also revealed that 20 percent of departments are concerned about the lack of available training in advanced evaluation techniques.

Some departments have addressed the need for more advanced skills and experience by setting up a central evaluation unit to provide advice on methodology and to participate in evaluation steering committees. The department of health has pursued evaluation quality assurance in a devolved environment via ensuring adequate skills and resources are available to program managers together with having structural arrangements in place, such as technical panels and steering committees.[10].

Another disadvantage to the devolved approach is that program staff are often too close to their program to view it objectively and to ask the hard, fundamental questions concerning its performance and the need for the program to continue to exist in the future. Again, external participation by a central evaluation unit or by peers from other programs in working groups or steering committees have been one way of attempting to address this. External participation has often included DoF for major evaluations, and this has been another means of fostering objectivity and rigor.

In only one agency, the Aboriginal and Torres Strait Islanders Commission (ATSIC), is there a separate evaluation body–the Office of Evaluation and Audit (OEA)–that has statutory independence. The independence of the OEA helps to provide an answer to claims of ethical difficulties and corruption in the administration of some ATSIC programs. A body such as OEA can be effective in ensuring that accountability objectives are met. The impact of its evaluations and reviews can be reduced, however, if they are perceived to lack fluency in program understanding and if they do not secure ownership by ATSIC program managers.

Australian National Audit Office

The national audit office has played a valuable role since the inception of the formal evaluation strategy. In endorsing the strategy, Cabinet agreed with the proposition that 'it is expected that (the national audit office) would contribute to the proposed evaluation strategy through audits of evaluation processes within departments and agencies, including their follow-up on evaluation findings .

Since 1990, the audit office has pursued this 'sheepdog' role vigorously, both with respect to line departments and to DoF. (It is notable that the Canadian Auditor General has played a similar role.)[11] The Australian National Audit Office (ANAO) has conducted six performance audits into the evaluation and performance information practices of a number of departments during that period, as well as on the overall, government-wide state of play with the

[9] DoF has provided introductory evaluation training to over 3000 public servants since 1991.

[10] The department of health encourages quality evaluations through: selection of good quality officers to manage the evaluation; involvement of internal and external stakeholders; ensuring technical advisory panels are available to help assess the work of consultants; having steering groups available to help manage consultants; and ensuring sufficient resources are available for the evaluation.

[11] See, for example, Auditor General of Canada 1996.

evaluation strategy. It has also published two good practice guides, one of which was prepared jointly with DoF.

In addition to these reviews of evaluation and performance information, the national audit office has also placed an increasing emphasis on the conduct of performance audits into the economy, efficiency and effectiveness of programs. The audit office completes about 40 performance audits annually, and they now account for about one half of the office's overall activity. The audit office takes care to ensure that its performance audit activities - which can be regarded as a form of evaluation - do not overlap or duplicate those of departments, and so do departments and DoF when planning their own evaluation priorities.[12]

The impact of the audit office's activities has been felt in several ways. First, they have focused attention on evaluation as a legitimate and important area for senior management attention in departments.

A second impact was felt in the earlier years, when the audit office pursued its performance audits into evaluation (and into program administration more generally) with a 'gotcha', faultfinding zeal. The impact and value-added of such an approach is highly doubtful as it strongly discouraged the 'victim' departments from ownership of the audit findings. The resistance of these departments to accepting the audit office findings was often evident in their formal, published responses to the audit office reports.

A 'gotcha' approach may have satisfied a narrow interpretation of the accountability function of an audit office, particularly in its reporting to parliament, but it undermined the potential value-added contribution that a considered performance audit could provide to a line department.

In more recent years, with a new Auditor-General and a different audit philosophy in the office, there has been a stronger emphasis on finding ways to help departments improve their performance. A high priority has also been attached to the identification and sharing of good practices, and the audit office has been pro-active in disseminating these among departments.

Other Success Factors

Having a government-wide evaluation effort, involving all departments, has proved helpful in developing a general climate of expectation that evaluation will be conducted and used, and in developing an evaluation community, especially in Canberra. It has also helped to develop a labor market for evaluation skills, including advanced data analysis skills. The labor market includes the growing number of staff with experience in evaluation units, in the various economic research bureaus, and in the national statistical agency.

One expression of this community has been the monthly meetings of the Canberra Evaluation Forum. The meetings have been organized by a steering group of departments, with DoF support, and each involves several speakers and discussants of topical evaluation issues. About 100 participants attend each month.

[12] Auditor-General of Canada 1996; ANAO 1997b.

The sharing of insights and good practices through these meetings has strongly encouraged networking. There have also been several special-interest conferences and seminars on particular evaluation issues organized by DoF and others, on issues such as the evaluation of policy advice and evaluation/audit links.

A feature of the Australian scene has been the frequent availability of commercially-organized, for-profit, conferences on evaluation and other performance measurement issues, and on public sector reform issues more broadly. Various departments, including DoF, work collaboratively with conference organizers to identify topical issues and provide conference speakers. The conferences allow an opportunity for federal public servants to be exposed to evaluation issues in state governments, local government and the private sector, and academia. However, the contribution of academia to ECD in the federal government has been limited.

The role of parliament has not lived up to the somewhat ambitious aims of the designers of the evaluation strategy, who viewed accountability to the parliament as one of the foundations of the public sector reforms, including the evaluation strategy. In practice, parliament has generally possessed neither the infrastructure resources nor the perspective to focus on the insights into program performance which evaluation findings can offer. While parliament exercises a general oversight role, including of annual appropriations, it has provided little scrutiny of strategic issues of performance, preferring instead to focus on administrative errors that might embarrass the government.

But there have been some notable exceptions to the narrow focus and interests of parliament, and these have involved parliamentary committees inquiring into issues such as the Financial Management Improvement Program and service quality.[13] These have been useful in emphasizing performance issues, such as the impact of government programs on their ultimate clients, to departments and to public servants more generally.

Finally, there is a number of success factors that are often taken for granted in Australia, but that become evident when making cross-national comparisons, particularly with developing countries that do not possess a well-developed public service infrastructure:

- strong institutional and human capacity in the public sector;
- well-developed management capacity;
- public service managers with a reputation for integrity, honesty and impartial advice;
- well-developed accounting standards and systems;
- a tradition of transparency and accountability in the conduct of government business; and
- a credible and legitimate political executive.

[13] Parliament of Australia 1990.

Current Developments and Prospects

The new government, elected in early 1996, has expressed considerable unhappiness with the efficiency of the federal public service and considers it to be rule-bound and caught up in red tape. It has also noted with dismay, evaluations that have shown public service efficiency to be lagging considerably behind that of private sector best practice, and these comparisons have strengthened its resolve to seek a smaller, more efficient public sector.[14] The government has therefore embarked on a wave of major public sector management reforms.

The new Cabinet has directed that Ministers and their departments review the nature and extent of continuing need for existing government programs; and it has expressed the expectation that competitive tendering and contracting processes be applied by departments to their programs wherever possible. These types of review require a close scrutiny of performance to be successful. In particular, the application of competitive tendering and contracting necessitates a clear understanding of program objectives, followed by ex ante assessments of the performance of alternative tenders (in-house and external). Once contracts have been let, there is a need for ongoing performance scrutiny, and at the completion of contracts, a review of past performance; this information then feeds back into decisions about the next round of contracts which are to be put out to tender. Evaluation of performance is central to all of these activities.

The government's initiatives are part of a strong push towards commercialization and the private sector provision of public services, and have already resulted in a significant downsizing in the number of public servants, with further larger reductions in prospect. Under some authoritative scenarios, in a decade, the size of the public service could be only a fraction of its recent levels.

The government is also taking steps to achieve sharper accountability for public service managers, together with fewer centralized controls and fewer formal requirements, partly via a strongly devolutionary approach. Departmental CEOs, who are on employment contracts, will be required to perform to high standards. These expectations are being made more explicit in legislation on financial management and accountability currently before parliament, and will increase pressure on CEOs to ensure high standards of corporate governance.[15] This may create both the scope and a requirement for the national audit office to take a greater quality assurance role in performance measurement and reporting than in the past.

Service delivery agencies will be required to set explicit customer service standards, with actual performance being reported publicly, including to parliament. The focus on performance will be further enhanced by the government's decision to adopt accrual accounting–this will facilitate scrutiny and comparisons of departmental performance. Changes to output/outcomes reporting are also in prospect, and these would seek to marry the output specification and focus of governments, such as those of New Zealand and several of the Australian states and territories, with the outcomes and performance focus of the federal Australian government. This development would also invite closer scrutiny of departments' planned and actual performance.

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[14] Reith 1996; MAB/MIAC 1996. The government has also favorably acknowledged the existence of "a system of performance management and program budgeting based upon an explicit evaluation of outcomes". (Reith 1996, p.ix)

[15] See ANAO 1997.

Collectively, the latest wave of reforms are likely to result in very considerable changes in performance management, accountability and reporting. For these reforms to be successful, however, there will need to occur a high level of scrutiny of departmental and CEO performance.

This environment helps explain and put in context Cabinet's recent agreement to the replacement of the formal requirements under the evaluation strategy by a principles-based approach. This approach emphasizes the use of evaluations and other performance information for performance management purposes, including links with corporate and business planning and the other reform initiatives now underway. Thus the approach in one sense reaffirms the merits of the Financial Management Improvement Program and of program budgeting. The new approach continues to emphasize the advantages in planning, conducting, reporting and utilizing evaluation findings, the main difference with the previous evaluation strategy now being the absence of formal requirements.[16]

How should the new approach be viewed? If the judgment is made that at least part of the success of the requirement-based approach was that it mandated evaluation activity, then there will be some risk with a new approach that intentionally excludes such formal requirements.

But a counter-argument is that the focus of concern should be with outcomes, not with processes to achieve them. If the public sector management framework is such that it achieves a strong focus on performance and outcomes, then this provides support to devolutionary approaches that provide management with the autonomy to achieve this performance in any manner it chooses. Put another way, in a government where performance and output measurement are strengthened, and there is greater accountability for results, there is scope to provide departments with greater autonomy and flexibility.[17]

One way of interpreting the new approach to evaluation is that it implicitly accepts performance measurement as an integral part of performance management[18]–reflecting a philosophy that if the environment of public sector governance is strongly conducive to evaluation being conducted and used, then that will happen. Thus the emerging public sector environment would be expected to be even more encouraging of evaluation than in previous years. The danger in this expectation is that it might mirror a similar but erroneous one in the early 1980s, when it was assumed that if the structural framework of public service management was 'correct', then an evaluative culture would almost automatically follow.

The impact of the new reforms on the culture and management of the public service will partly depend on progress already achieved since the early 1980s. To the extent that an evaluation culture–including management commitment to review and learn from past performance, and an evaluation infrastructure–has already been achieved, it will enhance the speed and extent of impact of the new reforms.

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[16] And yet even some of the formal requirements will remain, but in a different guise: departments will continue to be issued guidelines for the reporting to parliament about their annual appropriations, and these will now include the need for summary statements of evaluation intentions (i.e., plans). In addition, guidelines for preparation of departments' annual reports will note the need to report on past performance, including as revealed by completed evaluations and other performance information.

[17] This approach is advocated by the World Bank in its recent World Development Report (World Bank 1997).

[18] In contrast, it could be argued that the earlier requirement-based approach had been added on to the then-existing suite of reform initiatives in the 1980s almost as an afterthought. If that is a fair interpretation, then it would mean that it had been a very effective afterthought.

Conclusions from the Australian Experience

The requirements-based, formal evaluation strategy in Australia constituted a model of central force-feeding to help ensure the planning, conduct, quality and use of evaluation. It reflected the belief that managers would not do this if left to their own devices. Formal requirements and a whole-of-government approach helped to kick-start the process and achieve significant momentum, but it is worth bearing in mind that 'winning hearts and minds' cannot be mandated. It is not formal rules and requirements that determine the extent of the conduct and use of evaluation findings–it is the commitment of individuals and their institutions, and the nature of their understanding and motivation.

The recent move to a principles-based approach reflects the evolution of governance arrangements and the particular circumstances of the Australian scene. This evolution represents a migration from tight to loose controls over departments and their conduct.

The Australian experience provides a wealth of lessons, which can be drawn from. However, although it is possible to identify features of that system that have contributed to the substantial success achieved so far, this does not necessarily mean that these success factors are *preconditions* for success.

Some of the key success factors have been:

- macroeconomic pressures that have led to tight budgets and a priority on finding ways of achieving better value for money;
- a whole-of-government approach to help achieve and maintain momentum in ECD;
- a powerful department (DoF) willing to champion evaluation, react to changing circumstances and identify new opportunities for influence and development;
- having a second central agency (the Auditor-General) willing to prompt and prod departments to focus on evaluation and performance management more broadly;
- a budget agency (DoF) able to link evaluation into both the budget process and into program management reforms;
- the implementation of a number of related public sector management reforms that emphasize bottom-line results and outcomes;
- the support of Cabinet and a number of key Ministers, and the emphasis they have placed on having evaluation findings available to assist their decision-making;
- the priority given to evaluation in several large and important line departments, which has helped to highlight and legitimize it; and
- the devolutionary approach to evaluation within line departments, which has helped to mainstream evaluation as one of their core activities, together with internal quality assurance processes.

ANNEX 15:
THE UNITED KINGDOM'S NEXT STEP AGENCIES

The United Kingdom "Next Steps" program establishing Executive Agencies separate from government departments has attracted widespread international interest. As of November 1, 1995 there were 109 Executive Agencies and, additionally, two departments operating fully on Executive Agency lines (Table A15.1).

These agencies employed 363,880 civil servant, or about two-thirds of the total. By 1997, the total employed in executive agencies is expected reach 75 percent of all civil servants. Each agency has a framework document, which sets out objectives and performance targets. Agencies are reviewed every five years to consider whether they still serve their purpose, whether they could be privatized as an enterprise, or whether they could be abolished.

Table A15.1: United Kingdom: Executive agencies by size, 1995

Executive Agency	Staff
Social Security Benefits Agency	66,650
Inland Revenue	54,560
Employment Service	39,850
HM Prison Service	38,935
HM Customs and Excise	24,130
Defense Evaluation and Research Agency	11,680
Court Service	9,845
RAF Maintenance Group Defense Agency	8,945
Social Security Contributions Agency	8,900
HM Land Registry	8,510
RAF Training Group Defense Agency	7,410
Army Base Storage and Distribution Agency	6,400
Social Security Child Support Agency	5,985
Naval Recruiting and Training Agency	5,375
Sub-total	297,175
Other agencies	66,705
TOTAL	**363,880**

The chief executive is not a permanent civil servant, but on contract. The chief executive is responsible for the agencies' performance to the minister, but the minister remains responsible for policy. One of the major attractions of the Next Steps approach is a clearer focus on the performance of the agency, which, in turn, can be the basis for providing greater authority to the agency for management decisions. A precondition for efficient operation of the Next Steps agencies was the 1984 Financial Management Initiative which greatly improved accountability over financial resources, and the National Audit Act of 1984 which expanded audits to include efficiency and effectiveness audits.

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