

**ASIAN DEVELOPMENT BANK**

**TAR: PRC 36150**

**TECHNICAL ASSISTANCE**

**TO THE**

**PEOPLE'S REPUBLIC OF CHINA**

**FOR**

**FISCAL MANAGEMENT REFORMS**

**November 2002**

## **CURRENCY EQUIVALENTS**

(as of 31 October 2002)

Currency Unit	–	yuan (CNY)
CNY1.00	=	\$0.1208
\$1.00	=	CNY8.2769

On 1 January 1994, the dual exchange rate system of the People's Republic of China was unified. The exchange rate of the yuan is now determined under a managed floating exchange rate system.

## **ABBREVIATIONS**

ADB	–	Asian Development Bank
EBF	–	extra-budgetary funds
GDP	–	gross domestic product
IMF	–	International Monetary Fund
MOF	–	Ministry of Finance
PBC	–	People's Bank of China
PFB	–	provincial finance bureau
PRC	–	People's Republic of China
SDPC	–	State Development Planning Commission
SOCB	–	state-owned commercial bank
TA	–	technical assistance
VAT	–	value added tax
WB	–	World Bank

## **NOTES**

- (i) The fiscal year of the Government ends on 31 December.
- (ii) In this report, "\$" refers to US dollars.

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## I. INTRODUCTION

1. The Government of the People's Republic of China (PRC) requested the Asian Development Bank (ADB), during the 2002 Country Programming Mission, to provide technical assistance (TA) support to strengthen fiscal management as the PRC enters the third decade of its transition to a market economy. A Fact-Finding Mission visited the PRC in August 2002 and reached an understanding with the Government on the TA.<sup>1</sup> The TA is included in the 2002 TA program. The logical framework is in Appendix 1.

## II. ISSUES

2. Macroeconomic management and the fiscal functions of the Government are not effectively coordinated in PRC. Traditionally, much of the fiscal planning process had evolved around the needs of a centrally planned economy, with limited coordination between the Ministry of Finance (MOF) and the State Development and Planning Commission (SDPC) at the central level. Until the initiation of reforms in 1999, spending priorities had been largely determined at the central level, with little discretion given to the line ministries in planning or determining expenditures. The significant support provided through Government-directed infrastructure investments or debt issuance to restructure the domestic banking sector has been treated outside of the fiscal envelope, for purposes of policy formulation. The MOF has played a primarily allocative role, along with some monitoring functions.

3. Given the size of the PRC and its economy, public sector resource management and establishment of overall macroeconomic and strategic priorities have posed significant challenges. There are 22 provinces and 5 autonomous regions, each with an average population of 45.3 million; and 4 municipalities in Beijing, Shanghai, Tianjin, and Chongqing, each with an average population of 16.8 million. The PRC has 331 prefectural units, 2,109 country-level units, and 44,741 township-level units.

4. Despite these issues, PRC has managed to keep budget deficits at a manageable level, close to less than 1.5% of the gross domestic product (GDP) until 1996. Since 1997, however, fiscal deficits have grown, reaching 2.8% of GDP by 2000. While deficits declined slightly in 2001, the upward trend continues, given the Government's expansionary fiscal stance in 1998-2002. For instance, three fiscal stimulus packages were introduced over 1998-2000<sup>2</sup> to cushion the impact of the Asian financial contagion. While revenues, supported by enhanced tax collection, increased from 12.1% of GDP in 1997 to 17.4% in 2001, public expenditures grew faster, reaching 20% of GDP by 2000. In nominal terms, public expenditures grew at around 6.5% annually over much of the 1990s.

5. While the PRC has embarked on commendable reforms in fiscal management, several issues need to be effectively addressed. First, the budget is not comprehensive. Under the centrally planned system, the budget was treated as an accounting tool, capturing only part of the resource allocations, with all major revenue and expenditure decisions taken as part of the 5-year central plan. The revenue collection mechanism almost collapsed with the adoption of market-oriented reforms in the late 1970s. Overall Government revenue fell from 35% of GDP in 1978 to 11.4% in 1996. The declining trend led all levels of government to impose a wide range of fees, levies, and surcharges to generate significant extrabudgetary funds (EBF) to offset the

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<sup>1</sup> The TA first appeared in *ADB Business Opportunities* in July 2002.

<sup>2</sup> Together, they amounted to CNY360 billion (\$43.5 billion): CNY100 billion in 1998, CNY110 billion in 1999, and CNY150 billion in 2000.

revenue loss and growing expenditure responsibilities. The off-budget revenues and expenditures are particularly evident at the lower levels of government. While overall government revenue had recovered to half of the pre-1980 levels by 2001 because of the fiscal reform initiatives adopted in 1999, EBFs have not declined in any significant manner.

6. Published data indicate that EBFs and off-budgetary expenditures grew from 2.6% of GDP in 1980 to 5.7% of GDP by 1996, before declining to 4.1% in 1999. Independent audits by MOF and the State General Audit Agency estimate these unauthorized funds and fees in the range of 8-10% of GDP. At this magnitude, the rapidly growing EBFs and other off-budget funds<sup>3</sup> account for more than half of all consolidated resources of the Government. If quasi-fiscal expenditures such as directed credit to state-owned enterprises were added, the Government's extra budgetary spending would be close to 24% of GDP. While EBFs have provided flexibility to finance local initiatives without having to seek central approvals and allocations, they have impeded expenditure control, thus, adversely affecting macroeconomic management. Off-budget spending has eroded fiscal discipline and significantly reduced the overall budgetary performance of the Government in relation to economic stabilization, regional equalization, and resource allocation. Fees and extra charges in health and education sectors, in particular, have had an adverse impact on the poor. Oversight, transparency, and accountability with regard to EBFs are limited.

7. Second, budget preparation is not fully integrated with the fiscal cycle or the overall planning process. It takes place late in the fiscal year, and is not well coordinated between the central, provincial, and subprovincial levels. As a result, the spending units do not receive their appropriations in time. Although the National People's Congress approves the overall budget, MOF engages in negotiations with the spending units and adjusts the budget throughout the fiscal year. The link between the budget and overall strategic priorities is weak. Annual budgets are prepared and implemented with a distinction between basic, recurrent expenditures and project outlays, with the latter including both capital and recurrent expenditures. Basic expenditures are estimated through norms of the past and are seldom discussed or changed. MOF manages the recurrent budgets in relation to projects, while the SDPC deals with the capital budgets. This poses coordination difficulties and impedes effective fiscal planning, since MOF does not play any role in determining new capital investments, but is presented with information on the recurrent needs only upon approval of the new projects.

8. Third, there is no effective framework to account for or analyze the contingent liabilities stemming from the quasi-fiscal operations to finance investment projects, social expenditure needs of other state-owned entities, and the implicit pension debt. To meet the financing requirements, the People's Bank of China (PBC) has lent more than CNY460 billion (\$55.6 billion) to the four state-owned commercial banks (SOCBs) and over CNY1 trillion (\$121 billion) to the three policy banks. While directed credit has gradually declined, it still accounts for about 3-5% of GDP at present. Overall public debt planning is not well integrated with fiscal policy. For instance, the four asset management companies that operate at present, each established with CNY10 billion in operating capital, have issued interest-bearing bonds worth CNY820 billion to the SOCBs and policy banks in return for over CNY580 billion of the loans extended by PBC.

9. Fourth, while significant tax reform measures have been introduced, revenue adequacy continues to be a problem. The formal tax system contributes only 16% to GDP and consists of

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<sup>3</sup> In the PRC, EBFs comprise surtaxes, levies, and other types of user charges that various ministries, government departments, and administrative units can levy. All other funds are categorized as off-budget funds, including, self-raised funds, enterprise contributions to local and central governments, social security funds, and tax exemptions.

various taxes that are distortionary in their impact. For instance, although enterprises in coastal areas have received favorable income tax treatments, the Government does not undertake periodic assessments to determine whether tax rebates should be continued or eliminated in a timely manner. Joint-venture enterprises enjoy tax benefits, while domestic enterprises in the same sectors face unfair competition. Although provinces can determine the local tax rates, most of the direct taxes and key indirect taxes have a narrow base and generate relatively little tax revenue except in the larger provinces or municipalities.

10. Fifth, while the fiscal decentralization process has reassigned revenues, it has paid limited attention to the mounting expenditure burden at the provincial and subprovincial levels. The dismantling of the central planning system led to major changes in the overall tax base and in the tax-sharing arrangements between the center and the provinces. In general, tax sharing is not adequate and has over the years aggravated horizontal and vertical imbalances across different tiers of the government, and distribution of revenues has generally favored rich localities. As provincial growth rates diverged during the transition, so have public expenditures. As a result, regional disparities in fiscal spending and service provision are large by international standards. The combination of heavy responsibilities and inadequate transfers has meant that the levels of service provision vary considerably in line with local economic potential. Local governments in the poorer regions are unable to fulfill their expenditure responsibilities, and provide inadequate levels of vital public services. These problems call for rationalization of intergovernment fiscal transfers.

11. Sixth, there is lack of coordination in formulating fiscal and monetary policies. At a basic level, MOF aims at lower interest rates on Government securities to lower the cost of financing. Although there is an auction system in place for the sale of securities, there is also an implicit ceiling on the interest rates. This deters PBC's role in effective monetary policy formulation and coordination. While PBC prescribes a floating interest rate system and short-term rolling over of debt, MOF has issued fixed-coupon securities, which may increase the long-term risks faced by the commercial banks that hold these instruments. There is no integrated approach in place to evaluate the implications of debt issuance through treasury securities versus lending through SOCBs for long-term fiscal and monetary policies.

12. Finally, budget execution suffers from significant weaknesses. The current internal control systems are not designed to effectively trace the use of funds. In addition to leakages stemming from the recourse to EBFs, system wastage and misuse of contingency funds occur. There is no capacity to assess the veracity of the final statements produced by the departments within MOF and the provincial finance bureaus (PFBs). These constraints have reduced the credibility of fiscal reporting and internal controls.

13. Recognizing these difficulties, the Government has undertaken a number of key reforms. Since the late 1990s, with advisory support from the International Monetary Fund (IMF) and the World Bank (WB), public expenditure management has received high priority as part of the overall budget reform package. This package includes the enactment of the Budget Law, introduction of new procedures for budget preparation and approval, adoption of a new budget classification scheme, and strengthening of audit practices. MOF has been restructured, and a treasury department was established in 2000. It has introduced measures to consolidate all budgetary transactions into a treasury single account, and a pilot is under way in six key central-level agencies. ADB's past TAs have supported an evaluation of subprovincial fiscal relations and efforts to reduce EBFs at the central level. WB undertook a public expenditure review in 2000 and a study on intergovernmental fiscal relations in 2002, both of which have highlighted the constraints outlined above. The Government has sought the proposed TA to enhance

macroeconomic and fiscal coordination and strengthen internal controls. ADB will coordinate with IMF and WB in implementing the TA.

### III. THE TECHNICAL ASSISTANCE

#### A. Purpose and Output

14. The goal of the TA is to strengthen fiscal management in the PRC. This is to be achieved by (i) improving macroeconomic and fiscal coordination to meet national strategic priorities leading to a fair and equitable distribution of growth across the provinces; and (ii) instituting sound internal control systems to ensure that the budget is executed effectively. The outputs include (i) recommendations to MOF and the State Council for improving the linkage between established policy priorities, and budget formulation and resource allocation in key sectors; and (ii) redesigned internal control systems within MOF and PFBs to improve the use of budgetary funds.

#### B. Methodology and Key Activities

15. The TA will have two components. The key activities are listed under each.

##### 1. Component A: Strengthening Macroeconomic and fiscal Coordination

- (i) Provide overall institutional capacity building support to enhance coordination between macroeconomic priorities and fiscal policy formulation.
- (ii) Enhance the interface between MOF and the line ministries to strengthen budget formulation and execution.
- (iii) Evaluate budgetary and off-budgetary allocations to eliminate support to state activities that crowd out the private sector.
- (iv) Streamline EBFs to improve the linkage between expenditures and strategic priorities.
- (v) Recommend measures to rationalize expenditure and revenue assignments at all levels of the government, based on efficiency (choice and economies of scale) and equity (access) considerations, to align macroeconomic priorities and fiscal functions.
- (vi) From work already undertaken by MOF, assess the current tax and fiscal levy policies and tax-revenue sharing arrangements to improve income redistribution across provinces.
- (vii) Support the transition to medium-term budget planning to strengthen the link between macroeconomic planning, fiscal policy formulation, and budgeting.
- (viii) Develop a sound methodology and implementation framework for effectively integrating quasi-fiscal means of financing and other contingent liabilities in formulating the medium-term budget.
- (ix) Evaluate the coordination between MOF and PBC in formulating fiscal and monetary policies, and prepare a position paper with recommendations and appropriate institutional arrangements to achieve greater coordination.
- (x) Through in-country and external training seminars, enhance the skills and capacity of policy and budget officials in MOF and selected key ministries in macroeconomic and fiscal coordination and medium-term budget planning.
- (xi) Design for the State Council's consideration, a comprehensive strategy for fiscal management focused on achieving market economic objectives through efficient use of fiscal policy tools.

## **2. Component B: Instituting Sound Internal Controls and Audit on Budget Utilization**

- (i) Institute an effective internal control system in MOF and the PFBs of three selected provinces to strengthen budget preparation and execution, control EBFs, improve monitoring of treasury operations, and enhance fund tracing.
- (ii) Enhance the integrity and consistency of internal audits, with effective reporting to the senior management of MOF and PFBs.
- (iii) Strengthen the interface between the internal supervision departments and other line departments within MOF and PFBs as well as between MOF/PFBs and the other line ministries to enhance coordination in monitoring budget execution at all levels.
- (iv) Enhance the skills and capacity of financial controllers and auditors in MOF and the selected PFBs through in-country training seminars.

### **C. Cost Estimates and Financing Plan**

16. The total cost of the TA is estimated to be \$1,155,000 equivalent. ADB will provide \$875,000 on a grant basis from the ADB-funded TA program comprising the entire foreign exchange cost of \$634,000 and the local currency cost of \$241,000 equivalent. Component A will be allocated \$575,000 equivalent and component B, \$300,000 equivalent. Overall, the Government will contribute \$280,000 equivalent by providing counterpart facilities. Detailed cost estimates are in Appendix 2.

### **D. Implementation Arrangements**

17. The TA will engage a team of three international consultants to provide 17 person-months of advisory services and 4 domestic experts to provide 18 person-months of services. All will be recruited individually, in accordance with the *Guidelines on the Use of Consultants* and other arrangements for selecting and engaging domestic consultants. Their expertise will cover macroeconomic and fiscal coordination, tax and fiscal levy review, and internal control and audit functions. The terms of reference for the consultants are in Appendix 3. The TA is expected to begin in January 2003, and will be implemented over a period of 15 months. Any necessary equipment will be procured in accordance with procedures acceptable to ADB.

18. The International Department of MOF will be the Executing Agency for the TA, and the Policy and Fiscal Affairs Department and the Supervision and Inspection Department of MOF will be the Implementing Agencies for components A and B, respectively. The executing and implementing agencies will ensure smooth implementation of the TA and coordinate with all relevant agencies, including PBC. MOF will provide the necessary counterpart facilities and will facilitate the consultants' liaison with local governments, relevant agencies and organizations. An advance payment facility will be instituted to support the Government in organizing the external study visits.

## **IV. THE PRESIDENT'S DECISION**

19. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance not exceeding the equivalent of \$875,000 on a grant basis to the Government of the People's Republic of China for Fiscal Management Reforms, and hereby reports this action to the Board.

### TECHNICAL ASSISTANCE FRAMEWORK

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
<p><b>Goal</b></p> <p>Strengthen fiscal management in the People's Republic of China (PRC)</p>	<p>Progress in adoption of medium-term budget planning at the provincial and subprovincial levels</p> <p>Acceptance by the Ministry of Finance (MOF) of the new policy directions to enhance macroeconomic and fiscal coordination</p> <p>A position paper on EBFs completed</p> <p>Recommendations to revamped internal control and audit systems within MOF at the central level and the three selected provincial finance bureaus (PFBs) finalized</p>	<p>Report to the State Council</p> <p>Consultations with the Government</p>	<p>Recommendations for enhancing macroeconomic and fiscal coordination acted upon</p> <p>Sustained reduction in extra-budgetary funds (EBFs)</p> <p>No resistance to improved internal audit practices and internal control procedures</p>
<p><b>Purpose</b></p> <p>Enhance macroeconomic and fiscal coordination to achieve the national strategic priorities, leading to a fair and equitable distribution of growth across the provinces; and institute sound internal control systems to ensure that the budget is executed effectively</p>	<p>Budgetary allocations for key sectors reviewed, and revisions planned to align with strategic macroeconomic priorities, both at the central level as well as across provinces</p> <p>Position paper on monetary-fiscal coordination completed</p> <p>Report to the State Council completed and accepted by MOF</p>	<p>Review missions</p> <p>Consultations with MOF on interim recommendations and advisory support</p> <p>Draft and final versions of the report to the State Council</p>	<p>Government's commitment to take hard decisions on expenditure priorities, if the review suggests major changes</p>

	Assessments of internal control and audit procedures completed, along with capacity-building programs		
<b>Outputs</b>			
(i) Recommendations to MOF and State Council on improving the linkage between established policy priorities and budget formulation and resource allocation in key sectors such as education, health, agriculture, social security, environment, and science and technology (within 4 months of TA inception)	Interim recommendations formulated, finalized, and adopted by MOF prior to completion of the TA  Clear demonstration, through periodic interface during the TA, of inter-ministerial coordination for aligning budgetary allocations with medium-term strategic macroeconomic priorities	Policy assessments under the technical assistance (TA), through periodic reporting  Consultations with the Government  Domestic and external capacity-building initiatives	MOF and other key ministries being able to coordinate in a sustained manner  MOF to adopt the recommendations to enhance macroeconomic and fiscal coordination
(ii) Measures to enhance the usefulness of fiscal policy as a tool to achieve balanced growth across the provinces			
(iii) Position paper on enhancing coordination between monetary and fiscal policies (within 6 months of TA inception)	Position paper on monetary and fiscal policy coordination completed and discussed by MOF and People's Bank of China		
(iv) Redesigned internal control systems within MOF and PFBs to improve use of budgetary funds (within 3 months of TA inception)			
(v) Training programs and materials on macroeconomic and fiscal coordination (within 8 months of TA inception) and internal audits and controls (within 4 months of TA inception)	External study tour and domestic training seminars successfully completed, and training reports submitted by the participating officials		

<p><b>Activities</b></p> <p>All items identified in the Methodology and Key Activities Section of the TA paper</p> <p>Preparation of a comprehensive report to the State Council, based on the macrofiscal assessments</p> <p>Consultation and dissemination workshops</p> <p>External training program for selected officials, aimed at increasing awareness of internationally accepted sound practices for improving macroeconomic and fiscal coordination</p>	<p>Sound progress demonstrated by timely submission of interim assessments</p> <p>Report finalized</p> <p>Workshop materials and outcomes</p> <p>Final training report from those participating in the external training activities</p>	<p>Consultants' and the government's reports</p> <p>Monthly consultation meetings, and interim and final workshops</p> <p>Final review meeting</p>	<p>Availability of counterpart support, and full cooperation between all the relevant government agencies</p>
<p><b>Inputs</b></p> <p>35 person-months of consulting services, comprising 17 person-months of international and 18 domestic consulting inputs on fiscal assessments, analysis of tax and fiscal levies, and internal audits and controls</p>		<p>Periodic reports</p>	<p>Delivery of quality advisory services</p>

## COST ESTIMATES AND FINANCING PLAN

### Appendix A 2.1: Component A: Strengthening Macroeconomic and Fiscal Coordination (\$'000)

Item	Foreign Exchange	Local Currency	Total Cost
<b>A. Asian Development Bank<sup>a</sup></b>			
1. Consultants			
a. Remuneration and Per Diem			
i. International Consultants – 12 person-months	300	0	300
ii. Domestic Consultants – 10 person-months	0	60	60
b. International Travel	20	0	20
c. Domestic Travel	0	15	15
2. Equipment	0	10	10
3. Training Events			
a. Domestic Training Seminars and Workshops	15	0	15
b. Overseas Training Courses and Consultation visits to Governments	60	0	60
4. Report Preparation, Communication, and Translation	0	20	20
5. Contingencies	60	15	75
<b>Subtotal (A)</b>	<b>455</b>	<b>120</b>	<b>575</b>
<b>B. Counterpart Financing<sup>b</sup></b>			
1. Office Accommodation and Venue/Facilities for Training/Seminar	0	120	120
2. Local Counterpart Staff	0	80	80
<b>Subtotal (B)</b>	<b>0</b>	<b>200</b>	<b>200</b>
<b>Total</b>	<b>455</b>	<b>320</b>	<b>775</b>

<sup>a</sup> Funded from the Asian Development Bank-funded TA program.

<sup>b</sup> The Government will provide office space and basic furniture and telephone lines for consultants' use; and workshop facilities including space and related amenities.

Source: Asian Development Bank estimates.

**Table A 2.2: Component B: Instituting Internal Controls and Audit Functions**

Item	Foreign Exchange	Local Currency	Total Cost
<b>A. Asian Development Bank<sup>a</sup></b>			
1. Consultants			
a. Remuneration and Per Diem			
i. International Consultants – 5 person-months	125	0	125
ii. Domestic Consultants – 8 person-months	0	42	42
b. International Travel	10	0	10
c. Domestic Travel	0	15	15
2. Equipment	0	8	8
3. Domestic Training Seminars and Workshops	10	30	40
4. Report Preparation, Communication, and Translation	0	20	20
5. Contingencies	34	6	40
<b>Subtotal (A)</b>	<b>179</b>	<b>121</b>	<b>300</b>
<b>B. Counterpart Financing<sup>b</sup></b>			
1. Office Accommodation and Venue/Facilities for Training/Seminar	0	40	40
2. Local Counterpart Staff	0	40	40
<b>Subtotal (B)</b>	<b>0</b>	<b>80</b>	<b>80</b>
<b>Total</b>	<b>179</b>	<b>201</b>	<b>380</b>

<sup>a</sup> Funded from Asian Development Bank-funded TA program.

<sup>b</sup> The Government will provide office space and basic furniture and telephone lines for consultants' use; and workshop facilities including space and related amenities.

Source: Asian Development Bank estimates.

## OUTLINE TERMS OF REFERENCE FOR CONSULTANTS

### A. Consulting Services

#### 1. Component A: Strengthening Macroeconomic and fiscal Coordination

##### a. Fiscal Policy Specialist – Team Leader for Component A (international, 10 person-months)

1. The expert will be responsible for the overall management of technical assistance (TA) implementation and the timely delivery of quality interim and final reports. The expert will primarily assist the Ministry of Finance (MOF) staff and will be primarily responsible for initiating the work to streamline public sector reforms and educate counterparts and key policy makers on the importance of such reforms. Specifically, the expert will

- (i) Evaluate progress on the recommendations contained in the World Bank's Public Expenditure Review of 2000.
- (ii) Assess if the strategic priorities set for the key sectors in the short and medium term are in line with the overall development vision established by the State Council and National People's Congress, and if the current and proposed budgetary allocations would achieve such sectoral and overall national priorities; as part of this process, evaluate if a sound linkage could occur in a multiyear planning framework; within MOF and the key sector ministries; enhance awareness of the need for medium-term budget planning and expenditure prioritization.
- (iii) Explore the means to rationalize expenditure assignments at different levels of the government based on efficiency (choice, economies of scale), equity (access), as well as administrative capacity considerations.
- (iv) Assess the prevalence and extent of use of extra budgetary funds (EBFs) in the key sectors, and examine how to streamline the line ministries' recourse to EBFs to achieve better linkages between expenditures and strategic priorities.
- (v) Advise MOF and support the preparation of a position paper on EBFs clearly outlining the extent and pervasiveness of EBFs, and suggest reform directions to reduce recourse to them.
- (vi) Enhance the interface between MOF and the line ministries in the key sectors to ensure that the policy proposals seeking budgetary allocations are reviewed consistently.
- (vii) Evaluate budget and off-budget allocations to activities that should be carried out on commercial considerations, and institute sound policies to reduce ad hoc allocations; help the Government to redefine its role in providing public goods, while withdrawing from private goods production.
- (viii) Advise on measures to strengthen government fiscal operations to meet public expenditure objectives through rationalized expenditure allocation to ensure fiscal efficiency; help MOF in clarifying its policy objectives in the fiscal area and in achieving better linkages between overall national development priorities, medium-term sector priorities (in the key sectors identified in the scope), and budgetary allocations.
- (ix) Assess the management information system and extend it to include subnational levels to provide more accurate and timely information on local government expenditures.

- (x) Make an initial assessment of the coordination between MOF and People's Bank of China in formulating fiscal and monetary policies, and prepare a position paper for enhancing coordination in the short, medium and long term, with recommendations on appropriate institutional arrangements to achieve such coordination.
- (xi) Through in-country training seminars, enhance the skills and capacity of policy and budget officials in MOF and selected key sector ministries in medium-term budget planning.
- (xii) Advise on and coordinate the external study visit of selected Government officials to enhance their skills on macroeconomic and fiscal coordination.
- (xiii) Coordinate the work and inputs of the tax and fiscal levies policy expert, and the domestic consultant.
- (xiv) From the above, design a comprehensive strategy for expenditure management for the State Council's consideration, in a manner consistent with the ongoing fiscal management reforms at the national level; within the strategy, ensure a Government focus on providing public goods, while withdrawing from private goods production.

**b. Tax and Fiscal Levies Policy Expert** (international, 2 person-months)

2. The expert will be primarily responsible for analyzing the existing tax and fiscal levy policy and its role in intergovernmental fiscal relationships and recommend reform plans aimed at collecting and distributing fiscal resources more equally. Specifically, the expert will pursue these tasks

- (i) Reevaluate the tax revenue sharing system, which contributes substantially to the large and increasing fiscal disparities.
- (ii) Identify fundamental flaws of the current sharing of the value added tax (VAT) and enterprise income tax by the central and local governments and develop a strategy for using VAT more effectively for rebates.
- (iii) Recommend how to allocate more resources for equalization, by changing the basis for tax rebates, and formulate efficient measures for implementing the equalization program together with adjustments in tax assignments.
- (iv) Coordinate the work of the domestic consultants and provide effective advisory support to the team leader on tax and fiscal levy issues.
- (v) Establish better administrative mechanisms to implement equalization through a central transfer mechanism or central norms on provincial arrangements to ensure that equalization takes place.

3. Two domestic consultants will be recruited, to provide 6 and 4 person-months of services, respectively, in (i) fiscal policy and budget management; and (ii) tax and fiscal levy analysis. Their primary task will be to provide effective research, policy analysis, coordination, and logistics support to the international consultants. In particular, the experts will carry out but will not be limited to the following tasks:

**c. Fiscal Policy and Budget Management** (domestic, 6 person-months)

- (i) Review all recent Government regulations and orders regarding budget management, and synthesize the key requirements for the international expert.
- (ii) From existing MOF databases, compile a database on expenditure and revenue allocations at the central and provincial levels; focus on the key sectors to be

selected as pilots for enhancing macroeconomic and fiscal coordination, and undertake an in-depth analysis of the expenditure patterns and resource allocations to those sectors.

- (iii) Provide effective support in all aspects relating to fiscal policy formulation and budget management, as needed by the team to attain the objectives and scope of the proposed TA.
- (iv) Prepare detailed interim and final reports outlining the findings to the team leader on a timely basis.

**d. Taxes and Fiscal Levies** (domestic, 4 person-months)

- (i) From existing MOF databases, compile a database on tax revenue collections and revenue collected through fiscal levies/EBFs at central and provincial (aggregated from subprovincial) levels.
- (ii) Prepare and provide the team with a synthesis of the recent tax policy and fiscal levy changes, and how they have impacted on the relative collections.
- (iii) Provide overall support to the tax expert in assessing the revenue collections and assignments.
- (iv) Prepare detailed interim and final reports outlining the findings to the tax expert and team leader on a timely basis.

**2. Component B: Instituting Sound Internal Controls and Audit Functions on Utilization of Budget**

**a. Internal Control and Audit Expert/Team Leader for Component B**  
(international, 5 person-months)

4. The expert will be primarily responsible for advising MOF and the selected provincial finance bureaus (PFBs) in establishing a proper internal control and audit system, and will recommend reform plans aimed at improved fiscal discipline and accountability. Specifically, the expert will undertake the following tasks:

- (i) Evaluate the existing internal control systems at MOF and the selected PFBs, and compare existing practices against international sound practices for internal controls and audits in budget formulation and execution; formulate short-, medium-, and long-term reform measures aimed at improving financial management and reducing the scope for corruption.
- (ii) Give advisory support in instituting an effective internal control system at the central level within MOF and in the local PFBs of three selected provinces, with appropriate standards, and checks and balances, and with focus on budget preparation and execution, controlling EBFs, treasury operations, fund tracing and performance evaluation.
- (iii) Advise on implementing an internal audit system at the central and selected local levels, with focus on interim procedures as well as final outcomes, with the objective of ensuring integrity and consistency of internal control procedures, with effective reporting to the senior management of MOF and PFBs and the government.
- (iv) Help MOF and the PFBs in strengthening the interface between the internal supervision departments and other line departments within MOF and PFBs as well as between MOF/PFBs and the other line ministries to ensure better coordination in monitoring budget execution at all levels.

- (v) Formulate detailed terms of reference for the domestic consultants and oversee their inputs.
- (vi) Design appropriate training programs to enhance the skills and capacity of financial controllers and auditors in MOF and the selected PFBs through in-country training seminars.

**b. Domestic Consultants (8 person-months)**

5. Two domestic consultants will be recruited to provide 4 person-months each of services, respectively, in (i) internal controls and (ii) fiscal/financial statement audits. Their primary task will be to provide effective research, policy analysis, coordination, and logistics support to the international consultant.

**B. Reporting Arrangements**

6. The team leader for component A, and the internal control expert for component B will be responsible for delivering the reports, with appropriate contributions from the other experts. The team leader for each component will submit (i) an inception report 3 weeks after the start of their services, (ii) a regular monthly report until the completion of the TA; (iii) a midterm report for component A 5 months of TA inception, and an interim report for Component B 3 months of TA inception (which can be combined with the 3 monthly report); (iv) a draft final report 4 weeks before the conclusion of the contract; and (v) the final report, to be submitted within 2 weeks after comments from the EA and ADB are received and incorporated. The TA will begin in December 2002 and be completed in March 2004. Seminars and workshops will be organized intermittently during implementation period to invite comments from international and domestic experts in the field and disseminate the findings of the report. All reports will be translated and disseminated in the English and Chinese languages.

**C. Training Arrangements**

7. Capacity-building initiatives in component A will comprise (i) external study and consultation visits to one or two selected countries for up to five officials; and (ii) training seminars in the People's Republic of China (PRC) for which experts from developed and developing economies will be invited to share their experiences in macroeconomic and fiscal coordination. The external study visits will be combined with intensive short-term courses on fiscal policy-related issues offered by a major university in the United States or Europe. The Government and ADB will jointly select the participating officials, as well as the countries and institutions to be visited, with inputs and coordination support from the team of consultants.

8. For component B, the training in internal controls and audits for MOF and PFB officials will consist of a minimum of three seminars to be organized at three major centers in the PRC. International experts and budget controllers/auditors from developed economies and developing economies with more modern budget systems will be invited to the seminars. The Government officials participating in all the training activities will be required to submit a detailed training report, focusing on the lessons learned and how they will incorporate the tools and techniques disseminated at the training events in their operations within MOF and PFBs.