

**Annual Project Review Report  
Updated in July 2007**

**Project title:** Capacity Building to Support Pro-Poor Fiscal Reform in China

**Atlas Award ID.** 00039815 CPR04/518

**Period covered:** From January, 2006 to June, 2007

**PROJECT PERFORMANCE—CONTRIBUTION TO THE CP OUTCOMES**

**Element 1: Outcome**

This project is designed to support the widened implementation of on-going fiscal reforms in China as well as to address emerging policy development and other capacity needs in this area, with a particular emphasis on poverty reduction respective of fiscal reforms.

**Element 2: Update on outcome, situation analysis**

The year 2006 is the first year for China to implement the Eleventh Five-year Programme. The 11th Five-Year Programme approved in March 2006 sets out a strategy to secure:

- “comprehensive, harmonious, and sustainable” economic development;
- “accelerating the transformation of the economic growth pattern”;
- creation of a new “socialist countryside” through the promotion of services and infrastructure in rural areas;
- Moving away from excessive reliance on export-led growth, toward self-sustaining domestic demand.

Among the above, top priorities are given to the establishment of a harmonious society and the creation of a new socialist countryside. In the current stage when neutral fiscal policy is being practised, to build a harmonious society, public finance should aim to restructure and to gradually equalize public service delivery to all citizens. To create a new socialist countryside implies a shift of development priority from industry to agriculture, from urban areas to rural development. Deepened fiscal reforms are needed on both expenditure side and revenue side. On expenditure side, public resources should be directed more effectively into basic social service sectors such as basic education, public health, culture, employment, social security, ecological environment protection, public infrastructure, social safety, and etc, especially targeting rural population. On the revenue side, it means not only broadening tax base for increased revenue, but also making use of taxation as a macro-economic management tool to narrow the gap between the rich and the poor. This would have great implications for further poverty reduction in China and is in great consistence with the Xiaokang/MDG goals.

**Element 3: Updates on outputs**

From the beginning of 2006 to June 1, 2007, project activities carried out are all mounting steps towards the achievement of the 13 outputs under the 5 thematic project components. Concrete policy recommendations have been put forward in many cases while consolidated policy papers are expected to be delivered in the second half of 2007 and the year of 2008. Project inputs have been mainly in the forms of field surveys, workshops, training programmes, study tours, and drafting policy papers. Specific updates of outputs for various components are elaborated as follows:

**Component A: Enhanced capacity to formulate and implement pro-poor fiscal initiatives**

**Output 1. New options for pro-poor fiscal policy design developed, with a focus on county level finance:**

With support of the project, a country-level finance database has been set up with comprehensive economic and fiscal data collected from all the 2860 counties in different development modalities, which serves as an basis for analyzing and proposing sound pro-poor policy options to solve county and township financial bottlenecks, with differentiated and tailored responses.

Policy advices to enhance pro-poor fiscal capacities for less-developed regions have been developed based on field surveys covering over 12 provinces. The project introduced into policy consideration the classification of different types of counties based on comprehensive economic situation analysis. This policy recommendation has contributed towards the improvement of the “three rewards and one subsidy” policy package for less developed areas in China

The final draft of the policy paper on improving county level fiscal system and capacity is now being internally reviewed and will share with an international panel for review in August 2007.

**Output 2: Policy recommendations on strengthening sub-national government finance management**

Th project has supported comparative policy studies on local debt management. Based on international experiences learned from Australia and New Zealand, the project studies draw implications for China to estalbish sub-national government debt management system are drawn, and policy recommendations such as establishing sub-national government debt management system as soon as possible, establishing the mechanism for curbing the debt scale and risk warning in advance, putting the debt into budget management, and etc. In the international comparative studies, the level of local governments’ debt are assessed, legal basis for sub-national government borrowing, budgetary and reporting management for sub-natinal debt, credit rating for debt-accuring sub-national governments, as well as policy measures to resolve debts have been studied.

These are also useful building blocks for further steps in policy development for local debt management.

International comparative study on intergovernmental fiscal relations was also conducted in order to enable Chinese government to draw upon experiences from other countries such as Germany, a country with well developed intergovernmental fiscal system. Through study visits to the Federal, State and Municipal treasuries, the officials got first-hand information that have great implications for China on legislation of intergovernmental relationships, preparation of medium and long-term budgeting, macro-management by means of fiscal policies and the acceleration of public service equalization. These findings have been reported to the leadership of MOF for policy-making references.

## **Component B: Improved mechanisms and processes for budget formulation and management**

### **Output 3. New budget classification system introduced at all government levels:**

New budget classification system was introduced to all government levels from January 1, 2007, and the project has contributed to ensure the readiness of the system and prepared the capacity at the local levels. With support of the project, a guide book “Q&A on Government Revenue and Expenditure Classification Reform” has been developed and published as a guiding manual for the national roll-out of new budget classification. This manual is also used as training material for sub-national budget officials from all over the country on reform agenda, category transformation, budget execution, relevant software development and etc. translation of other countries’ budget classification and tables have been completed. And workshops have been convened to discuss emerging issues in rolling out new classification system to a nationwide scope.

### **Output 4. Revision process of budget legislation moved forward:**

Draft technical reports and policy recommendations on further revising China’s Budget Law have been prepared based on wide consultation, which was the main added value by the project support. The project has supported an IMF mission to provide technical assistance to MOF on budget law revision, and supported consultation between MOF and Budget Affairs Commission of Standing Committee of National People’s Congress, State Audit Office, Ministry of Agriculture, and field surveys to Guizhou and Guangdong Provinces. Meanwhile, a comparative study on China and US’ budget laws is being finalized. The agenda of Budget Law revision is still under senior-level discussion.

### **Output 5: Strategic framework for introducing performance-based and outcomes-oriented budgeting developed**

The project has conducted a study on performance-based budgeting and made recommendations to the Government of China highlighting the necessity of nurturing

performance-based and result-oriented culture, implementing the system with sufficient experimentation, and adopting a phased approach with multi-sector coordination. Since experimentation of performance-based and outcome-oriented budgeting has been designed and carried out in selected governmental departments and provinces, the project has further supported the exercise through facilitating exchange of experiences among the various experimental regions and review of pilots of performance evaluation.

### **Component C: Treasury reforms extended and accounting system reforms initiated**

#### **Output 6. Enhanced coverage and comprehensiveness of government accounting reforms:**

With the project support, policy recommendations have been made for China to reform its governmental accounting system, such as to establish the complete accounting system (including governmental accounting, non-profit organization accounting and entrepreneur accounting), to transfer the cash-basis accounting system into accrual-basis accounting system, and etc. By doing so, governmental assets and debt can be reflected completely, and risk-preventing and performance-based budgeting can have a good performing basis. This has provided good references for Chinese government to promote the transformation from budgetary accounting to government accounting in the future.

#### **Output 7: Recommendations for extending the Treasury Single Account (TSA) System and improving Cash Management systems**

The project has supported international consultancy for MOF on treasury single account and cash management.

On TSA, the project has made recommendations on improving the account system, payment procedures, and monitoring system based on international experiences. This has contributed to the smooth rolling out of the TSA to all budget units at central government level in 2006, to all provinces and two third of the prefectures nationally in 2007.

On Cash management, the project has facilitated further coordination between the MOF and the People's Bank of China (PBC). Through international consultancies, the project recommended on cash management methods to change the current cash reserve approach. Two particular recommendations have been made on how to manage cash: to move part of the cash reserve from currency account with PBC to fix-term reserve account with commercial banks; and to buy-back some state bonds. The recommendations have been fully reflected in the official policy issued by MOF in consultation with PBC at the end of 2006 – "Treasury Cash Management Methods."

### **Component D: Tax legislation and policy developed and adjusted to the needs of China's transition towards a market economy**

#### **Output 8. Strategic frameworks for the re-assignment of taxation powers, local**

**taxation reform and basic tax law formulation developed:**

The project has submitted to the National People's Congress a policy recommendation note on tax power assignment between central and local government. Key recommendations from the project include sharing law-making power on taxes with local government and delegate local government with power of setting up certain local featured taxes, under the precondition of not harming the integrated market. These recommendations have been considered in the drafting of the basic tax law by the financial and economic committee of NPC.

Domestic and international workshops have been convened by Tax Policy Department and Tax Legislation Department of SAT to discuss the theoretic rationalities, general principles and sound practices of tax power assignment and basic tax law formulation in other countries. With the audience being local finance officials from different parts of the country, the project also helped in preparing the capacity at local level for future enforcement of the law to be developed.

The medium-stage report about tax power assignment is being drafted and is expected to be finished in the 4<sup>th</sup> quarter of 2007.

**Output 9. Options and action plans for establishing a unified tax system for urban and rural areas and for modernizing the real estate tax system developed:**

With support of the project, current status of China's tax system, the necessity and pre-conditions for the unification, the route of unification and several issues for special consideration in the unification have been discussed and debated, preparing the ground for policy proposals in these regards.

Real estate tax development has been addressed from macro-policy framework level to technical level under the project. While the legislative power division, appraisal of property value, and the design of tax elements and tax preferences have been studied by MOF, Tax valuation techniques, the application of costing methods, and tax return method for real estates have been studied by SAT under the project.

On real estate tax, the project has recommended that the tax should be levied based on valuation of the property, valuation institutions should be set up within SAT system, independently from tax management departments, strategic planning of data collection and data-sharing should be established, capacities for data analysis needs to be enhanced and social environment for levying the tax should be prepared.

The project thus supported Chinese government to work out property tax reform agenda, and to find solutions to key problems in establishing real estate taxation valuation techniques and standards in China. With support of the project, the principle of pro-poorness and achieving social equity has been adopted while designing the real estate tax.

**Output 10: Options for enhancing tax and incentive frameworks for environmental protection development**

The project has prepared a technical report on environmental tax, which has been submitted to SEPA and proposing to the State Council of setting up a multi-sector coordination system to translate the report findings into policies. The project in particular recommended on structural adjustment and integration of environment related fees and taxes, enlarging CSO's roles and mobilizing civic participation in planning and enforcing environmental tax. International best practices on environmental taxation and legislation, administrative modes, supervisory modals, and examining techniques, which have great implications of adopting environmental tax in China, have been reflected in the report.

**Component E: Strengthened capacities in tax administration and broadened tax base****Output 11. Strengthened Institutional and Human Capacities for Efficient Tax Administration:**

With support of the project, current problems and priorities in tax administrative institutions have been identified, and domestic training courses have been organized for sub-national tax officials. Human resource management experiences in other countries and feasibility of introducing job hierarchy system in China's tax authorities have been explored through capacity building activities supported by the project. Trainees of the project put forward their policy recommendations to the central and local level governments, which resulted in concrete reforms, including 1) a pilot in Liaoning province to set up an institution to collect tax payer's feedbacks; 2) SAT e-system setting up two data bases to introduce policies and popularise tax knowledge for easy access of tax payers; 3) piloting in some provinces on-line tax reporting systems.

The project made recommendations on strategies and modalities of re-structuring the taxation institutions under the context of establishing e-taxation service system. The project recommendations will be fed into the reference frameworks for further institutional reform of the taxation system in China.

**Output 12: New options for broadening the tax base developed.**

The project has made great contribution towards enlarging tax base. The project has recommended on reclassification of tax-free vis-à-vis taxed merger and acquisition. The methods recommended has been reflected in the new income law, and helped in enlarging the tax base. Emerging taxation issues on non-residents' taxation, transfer-pricing, cross-border tax issues, tax treaty arrangements and international information exchanges have been studied and findings to be fed into the policy development for international taxation. Some new methods have been adopted in transfer pricing after the project's training on standardizing transfer pricing methodologies, which resulted in large tax increase from transfer dealings.

Policy consultancy has been done on emerging domestic taxation issues, covering the issues of tax collection of Non-profit Organization, taxation for small and medium-sized enterprises, tax policies for, and taxation treatment for domestic-funded and foreign-funded enterprises. The consultancy findings has made specific recommendations to new tax policies including 1) enlarged tax reduction preference scales for NPOs; 2) tax deduction for charity donations increased from 3% to 12%. 3) defined and enlarged scope of NPOs that benefit from tax-reducing donations.

### **Output 13. Capacity Assessment and recommendations to strengthen ICT systems for tax administration:**

The status quo of taxation computerization in China has been reviewed, and emerging problems in Golden Tax Project (Phase III) have been discussed under the project. Based on international consultancies and experiences, the project recommended particularly on risk management system. The recommendations have contributed to the new policies including 1) centralization of tax data management to provincial level, 2) development of risk copy plan, nation wide dissemination of comprehensive tax administration software.

## **Component F: Successful Management and Coordination of Project**

### **Output 14: Substantive Outputs of Project Components Integrated**

The first Annual Fiscal Reform Forum was organized in November 2006, with a focus on fiscal reform in support of rural development. The forum has successfully integrated substantive project outputs with priority reform agenda in the context of “building new socialist countryside”. It has facilitated intensive discussion on the issues including budget reform and local budget management challenges, financing rural development and basic social service, local taxation reform, debt and risk management at county and township levels, and sub-provincial fiscal transfer. Policy options have been proposed by presenters and discussants on meeting the key challenges facing local level government and rural areas in the pro-poor fiscal reform.

The participants to the conference come from all levels of government and associated research institutions. There are over 100 participants coming from local finance and taxation authorities of over 20 provinces. The conference has been deemed as a valuable capacity building exercise for the local participants in particular as for many of them, it brings a fresh but powerful pro-poor angle of analyzing budget and taxation issues.

The forum also launched a platform to promote multi-partner dialogues around the key issues of the fiscal reform. Apart from MOF and SAT, the forum also mobilized wider participation from NPC, NDRC, social service line ministries, Committee of financial affairs of CCCPC, policy research institutions such as DRC, CASS, MAI, etc. International organizations like DFID, UNICEF, WHO, World Bank, Asian Development Bank, Ausaid, contributed to the forum by providing resources and valuable expertise. As conceived, the annual forum will serve as a regular platform under the UNDP Pro-poor Fiscal Reform Project for policy-makers, academia, and various stakeholders and partners

to exchange views on emerging issues in on-going fiscal reforms, seeking to provide policy recommendations for the government.

#### **Element 4: Update on partnership strategies**

Over the past year, both the implementing agencies (MOF and SAT) and the executing agency, CICETE of Ministry of Commerce have built good collaboration relationships and worked closely in promoting the sound implementation of the project.

Participation are mobilized from various academic institutions like the Chinese Academy of Social Science, State Council's Development Research Center, Research Institute for Fiscal Science, Taxation Research Institute and many universities in field surveys, policy discussions, and workshop activities of the project.

DFID has continuously provided financial supports for project implementation and reviewed plans, progresses and outputs through the annual review exercise.

The IMF has continuously contributed to project implementation by providing valuable technical assistance in areas requested by MOF and SAT under the general framework of the programme, such as budget law revision, treasury cash management, and computerized tax administration.

The OECD has provided technical assistance for SAT in the field of anti-tax treaty abuse and mutual support of tax administration.

Other international organizations like World Bank, Asian Development Bank, WHO, UNICEF, and China-Australia Governance Programme sponsored by AUSAID have made great contribution to our project by providing needed expertise for the 2006 Annual Fiscal Reform Forum.

The successful implementation and well established platform by the project also attracted UNICEF to invest around 800,000USD into supporting China's pro-poor fiscal reform. Under the on-gonging project, UNICEF added component focusing on financing basic social services, which are integrated into the Component A of the project. With the UNICEF component (2007-09) joining the general result framework of the project, consideration of extending the project timeline accordingly is needed. Extension of the timeline till end 2009 is not to delay the implementation of key activities, but rather to be in line with UNICEF component to jointly launch some project results.

#### **Element 5: Recommendations and proposed action**

Generally the progress is on track. However, delivery of the key policy reports needed to be speeded up as the project moves to the third year. A number of key reports are expected to be finalized by end of 2007 and a series of consultations need to be conducted on the reports leading up to its finalization.

- For MOF side, policy study reports for (a) pro-poor fiscal policy focusing on county

and township level finance, (b) revision of budget legislation, (c) performance-based and outcomes-oriented budget management, and (d) tax power assignment are expected in 2007.

- For SAT side, medium-stage reports and policy suggestions for (a) introducing environmental tax, and (b) tax power assigning are expected in 2007.

## **EXPERIENCES AND LESSONS LEARNED**

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1. The project has been itself a capacity building process for the project managers and the government officials involved. One clear experience is that the project stakeholders are paying more and more emphasis on the pro-poorness of the project results. Examples are given in the report on designing real estate tax and tax policy regarding NGOs.
2. Participatory approach is promoted through the project as demonstrated through enhanced direct communication between the government and the civil society during the process of policy making and enforcement. Through capacity building exercises, local level policy makers on budgeting and taxation are more engaged in consultations by the central level governments in developing new policies.

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